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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957.

No. 535

R. J. REYNOLDS TOBACCO COMPANY,

Petitioner,

v.

THE UNITED STATES,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

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New York, N. Y.,
October 8, 1957.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

TO THE HONORABLE THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Petitioner, R. J. Reynolds Tobacco Company, respectfully prays the issuance of a writ of certiorari to review the judgment of the United States Court of Claims dismissing a petition for refund of income and excess profits taxes.

Opinion Below.

The opinion of the Court of Claims is reported in 149 F. Supp. 889 (1957). The opinion, together with the findings of fact, is set forth in the Appendix. Motion for rehearing was overruled without opinion.

Jurisdiction.

The judgment of the Court of Claims was entered April 3, 1957 and its order denying rehearing July 12, 1957. The jurisdiction of this Court is invoked under 28 U. S. C. § 1255, subd. 1, 62 Stat. 928.

Questions Presented.

Petitioner (hereinafter called Reynolds) made cash payments to employees under a profit sharing plan for each of the years 1940-1948. The purpose of the plan was to procure better services by encouraging employees to invest in company stock and by providing for annual payments of a share of profits to participating employees. The payments were in proportion to the stock held by employees and were without regard to dividends which were paid to all holders of stock, whether or not employees.

To prove the extent to which the payments were reasonable as compensation, Reynolds introduced in evidence substantial testimony and statistical data. The witnesses were not impeached and the Government introduced no evidence of unreasonableness.

A majority of the court below held that the payments were not compensation for personal services but were "the very essence of dividends" and therefore not deductible in computing taxable net income. The majority held that the payments could not be deducted on the further ground that no payment was proved reasonable in amount. Two judges concurred in substance on the first issue but refrained from passing on the issue of reasonableness.

The questions presented for review are:

1. Were the payments compensation for personal services?

2. Was the evidence sufficient as a matter of law to prove the reasonableness of any of the payments?

Statutes Involved.

The statutes involved are §§22(a), 23(a)(1)(A) and 115(a) of the Internal Revenue Code of 1939, as amended (53 Stat. 9, 12, 46). The text of these statutes is set forth in the Appendix.

Statement of the Case.

Reynolds is a New Jersey corporation with its executive offices and principal plants in Winston-Salem, North Carolina. Its business is the manufacture and sale of tobacco products, for the most part cigarettes.

Reynolds' profit sharing plan was adopted as a bylaw in August 1912. It provided for the annual payment in cash of not more than 10% of profits in excess of those earned in 1910 to employees who had been employed for a full year and had owned common stock for a full year.[1] Payments were in proportion to stock owned by employees and without regard to dividends paid to all the stockholders whether or not employed. Termination of employment ended participation under the plan.

Earlier in 1912, Reynolds' three major competitors, The American Tobacco Company, Liggett & Myers Tobacco Company, and P. Lorillard Company had adopted profit

[1] After 1918 there were two classes of common stock, "A" and "B", which ranked *pari passu* as to all rights and privileges, except that B stock had no vote and ownership thereof did not entitle an employee to participate under the profit sharing plan.

sharing plans providing for payment of 10% of profits in excess of those earned in 1910 to their respective presidents and vice presidents. By contrast, the Reynolds plan spread the payments down the line and measured participation by employee stock ownership. In the years at bar all four companies had profit sharing plans in operation, Reynolds and American without substantial change, and Liggett and Lorillard in modified form.

Over the years Reynolds applied a policy of broad but selective allotment of stock among employees. Since 1920 the allotments were administered by the committee of the Board of Directors which supervised wage and salary adjustments. Reynolds purchased stock and resold it to employees and supervised sales of stock to employees by retired employees and estates of deceased employees. The committee made allotments to individual employees after reviewing recommendations from supervisory personnel.

Some employees bought less than their full allotment of stock and some bought none at all. Some acquired stock other than by allotment, namely, by inheritance, gift or purchase without committee approval. It was the view of the Reynolds management that these imperfections "did not affect the overall sucess of the plan". (Finding 49) In management's judgment 2.2 to 5.6% of the participating employees received excessive payments in relation to their services and the excess amounted to 1.2 to 3.1% of the total compensation of the participating group. (Findings 50-51)

The number of participants during the years at bar ranged from 1,727 to 2,045 out of a total of approximately 12,000 employees. Stock owned by employees varied from about 5 to 6% of the total outstanding common stock. The incidence of stock ownership ranged from 100% of the

employees in the most responsible positions down to a nominal percentage of hourly workers.

The purpose of the Reynolds plan was found by the Court of Claims to be as follows:

> "The bylaw was set up to provide a plan for profit participation as an incentive to employees." (Finding 99)
>
> . . . . . .
>
> "The purpose of the plan was obviously to encourage employees to become owners of a share of the business, and, by reason of such ownership, would have a greater interest in its profitable operations and would give their best efforts to this end. The plan provided that such employee owners would not only share equally with other stockholders in regular dividend distributions, but would receive special profit-sharing distributions from profits which would result from the greater interest of workers." (Opinion, App. 8-9)
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> . . . . . .
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> "Bearing in mind that the bylaw adopted by plaintiff was prior to the enactment of the income tax laws, we cannot say that the plan was not designed to incite greater efforts on the part of its employees because of investment in the company. Further, we cannot say that the plan was designed for tax avoidance." (Opinion, App. 10)

With respect to the effect of the plan the court found: Ownership of stock by employees "was an incentive to efficiency and cost consciousness". (Finding 63) It attracted new employees and reduced employment turnover. (Findings 64-5) Purchasing, sales, manufacturing and management personnel were very efficient. (Finding 63) Reynolds' growth and earnings record were superior to those of its competitors. (Opinion, App. 5; Findings 52-60) "During the many years following the adoption of

bylaw XII, the operation of the plan thereunder materially aided the progress and development of plaintiff." (Finding 62)

No capital was raised by Reynolds as a result of employee purchases since none of the allotted stock was original issue and since Reynolds made no profit on its sales to employees. (Findings 16, 37)

Before 1949, pursuant to an early ruling by the Bureau of Internal Revenue, Reynolds and the Government both treated the payments as dividends for tax purposes. However, on its books and in its annual reports to stockholders and to the Securities and Exchange Commission, Reynolds always deducted the payments as an expense in determining annual net income.

In 1949, after the bylaw was amended in certain particulars not here significant (Findings 71-74), Reynolds applied to the Commissioner of Internal Revenue for a ruling as to whether the payments were compensation or dividends. The Commissioner ruled that the payments were compensation and would be deductible to the extent reasonable. Reynolds has deducted the payments in its tax returns for 1949 and subsequent years. In 1950 it filed the instant claims for refund for all open years, that is, 1940-1948[2]. In 1951 the Commissioner revoked the 1949 ruling and thereafter denied the claims for refund. He has also disallowed the deductions claimed in the returns for 1949 and 1950.

The issue of deductibility for 1949 and 1950 has been tried in the Tax Court of the United States, which held that the payments were compensation and deductible to the extent that the court found them to be reasonable. *R. J.*

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[2] The face amount of the claims sued for, $8,352,851.83, is reduced to about $5,300,000 as a result of adjustments under Section 734 (1939 IRC) and the amounts conceded to be excessive which are tabulated in Finding 50. The total amount of federal income and excess profits taxes paid by Reynolds for the years at bar was $150,164,284.44.

Reynolds Tobacco Co., T. C. Memo 1956-161, 15 T. C. M. 810 (July 6, 1956). The final order has not been entered in that case because the correct base period net income, necessary to the computation of the 1950 excess profits tax, cannot be determined until a decision in the instant case becomes final.

On the issue of reasonableness, in addition to the evidence reflected above (pp. 5-6) showing the effects of the bylaw on employee efficiency and company success, there were stipulated exhibits in evidence showing by employment categories the name, length of service, base pay and bylaw payments of each participating employee for each year. (Exhs. J-22-30). Findings 45 through 48 reflect the patterns of participation both by employment categories and by compensation ranges.

With respect to the officer group Findings 90 and 91 show a comparison of the compensation paid to the officers, both individually and as groups, of Reynolds, American, Liggett and Lorillard. Findings 92 and 93 show the ratios for the respective companies of executive compensation to net sales and earnings before taxes. In addition, the former president of Brown & Williamson Tobacco Corporation testified that the compensation (including bylaw payments) of the Reynolds executive group was reasonable. (Finding 101)

The Findings and Opinion show that the salaries of leaf buyers and salesmen, who worked over wide territories in direct competition with competing buyers and salesmen, were low in comparison to competitors'. The base pay of the other Reynolds employees, virtually all of whom worked in the Winston-Salem area, was at or below the going rates in the community. (Opinion, App. 5-6; Finding 66)

For the nine years at bar there were more than 17,000 payments to employees. Many of the payments were quite

small. For example, the Vice President in charge of sales, whose salary for the years 1945-1948 ranged from $30,000 to $43,500, received annual bylaw payments ranging from $464 to $932. The Solicitor and Assistant to the Chairman of the Board received a salary for the years 1946-1948 of $20,000 to $26,000 and annual bylaw payments from $69.40 to $559.20. For the year 1940, 110 foremen and 318 salesmen each received less than $200 per year, less than $4 per week. For 1948, 106 foremen and 82 salesmen received less than $200 per year. Of the 17,000 payments for the entire period some 6,900 amounted to less than $100 per year, that is, less than $2 per week. (Exhs. J-22-30)

Four executive officers of Reynolds who had reviewed the records of each participating employee testified that with stated exceptions the total compensation, including bylaw payments, of each employee was not in excess of a reasonable allowance for his services. As the court below stated (Finding 101):

> "In making their examinations, the four executives took into consideration the usual factors that enter into an appraisal of the value of an employee's services including his salary and bylaw participation, ability, performance in the job, responsibility, and length of service.".

The court below observed that this testimony was "in no way impeached" and held that it "must be given some weight". (Opinion, App. 13)

In denying the claims for refund the Government made no determination that the payments were unreasonable to any extent. (Opinion, App. 2) It "steadfastly maintained that the payments were preferential dividends." (Opinion, App. 6) It introduced no evidence to refute the testimony as to reasonableness or to prove unreasonable compensation. (Finding 101; Opinion, App. 13, 15)

Basis for Jurisdiction in Court Below.

The suit below arose out of Reynolds' claims for refund of income taxes and excess profits taxes which were disallowed by the Commissioner of Internal Revenue. The suit involves claims against the United States founded upon Acts of Congress and Federal jurisdiction is conferred upon the Court of Claims by 28 U. S. C. §1491, 62 Stat. 940.

Reasons for Granting the Writ.

The decision below that the payments were not compensation is in conflict with the decision of this Court in *Commissioner* v. *LoRue*, 351 U. S. 243 (May 28, 1956).

The decision of the majority that no payment was proved reasonable is wrong as a matter of law. It is predicated on irrelevant considerations, prompted by the error on the first issue, and conflicts with decisions of Courts of Appeal.

Argument.

1. Nature of Payments.

Section 23(a)(1)(A) allows the deduction of business expenses including "compensation" for personal services. Section 22(a) defines gross income as including "compensation" for personal service. The term has the same meaning in both sections.[3] The decision of this Court in *Commissioner* v. *LoRue*, *supra*, on the meaning of compensation under §22(a) is therefore controlling in like cases under §23(a).

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[3] *Joseph W. Frazer*, 4 T. C. 1152, 1155-7 (1945), *Acq.*, *aff'd* 157 F. 2d 282 (C. A. 6th Cir. 1946), *cert. denied* 329 U. S. 807 (1947); *Electric Storage Battery Co.*, 39 B. T. A. 121, 132 (1939), *Acq.*; I. T. 3795, 1946-1 C. B. 15, 16.

The court below found the purpose and effect of the Reynolds plan to be as follows:

> "The bylaw was set up to provide a plan for profit participation as an incentive to employees." (Finding 99)
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> "The purpose of the plan was obviously to encourage employees to become owners of a share of the business, and, by reason of such ownership, would have a greater interest in its profitable operations and would give their best efforts to this end." (Opinion App. 8-9)
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> • • • • • •
>
> "During the many years following the adoption of bylaw XII, the operation of the plan thereunder materially aided the progress and development of plaintiff." (Finding 62)

In *LoBue* the stock option plan "was designed to achieve more profitable operations by providing the employees 'with an incentive to promote the growth of the company by permitting them to participate in its success.'" (351 U. S. at 246) This Court concluded (*id.* at 247):

> "When assets are transferred by an employer to an employee to secure better services they are plainly compensation. • • • LoBue received a very substantial economic and financial benefit from his employer prompted by the employer's desire to get better work from him. This is 'compensation for personal service' within the meaning of § 22(a)."

By contrast the Court of Claims here concluded: "The payments are the very essence of dividends • • •." (Opinion, App. 10)

Although Reynolds in its briefs vigorously relied upon *LoBue* as controlling authority, the Court of Claims did not distinguish, discuss *or even cite it.* Its findings follow

almost verbatim the court commissioner's report filed a few days before this Court's decision in *LoBue*.

The opinion in *LoBue* indicates that the holding was not limited narrowly to stock option cases. Certiorari was granted "to consider whether the Tax Court and the Court of Appeals had given § 22(a) too narrow an interpretation." (351 U. S. at 246) The Court stated that there was nothing in the statute to indicate that "its broad coverage should be narrowed because of an employer's intention to enlist more efficient service from his employees by making them part proprietors of his business." (*Id.* at 247) The Court said, "It makes no difference that the compensation is paid in stock rather than in money." (*Ibid.*) The reasoning and the conclusions are not couched in terms of a reduced purchase price but in the broader terms of benefits conferred in any form upon an employee "prompted by the employer's desire to get better work for him." (*Ibid.*)

Here, as in *LoBue*, the result sought was better employee services. In both cases the method of securing better services was to encourage employees to invest in company stock. In both the benefits were in proportion to the stock purchased. In both the benefits were prompted by the employer-employee relationship and not the company-stockholder relationship. The benefits took a different form in the two cases. In *LoBue* the "carrot before the nose" was a stated price for the stock no matter how great the bargain might become by reason of increase in value of the stock; here the "carrot" took the form of annual cash payments after the stock was purchased, in addition to the dividends paid all stockholders. This difference alters neither the purpose nor the effect of the payments.

No capital was raised by Reynolds as a result of employee purchases. The only consideration for the bylaw payments was services. Accordingly, the payments were

to employees as such and not to "shareholders" within the meaning of § 115(a). The dividends paid to all stockholders constituted the distributions under that section.

The court below held (Opinion, App. 9):

> "In order to construe such distributions as increased compensation for services rendered it must be found that the employee holding the greatest number of shares contributed the most valuable service • • • or that other employees who purchased no shares, contributed nothing to the increased profits from which such dividends were distributable. This has not been proved."

Such requirement of exact equation of benefits received and services rendered is unprecedented and wholly unrealistic. By this standard, benefits conferred under employee stock option and stock purchase plans would rarely if ever be compensation. In all such plans the benefits are precisely related to the stock purchased but the relation to value of services that the Court of Claims would require rarely exists.

LoBue, for example, had three years in which to exercise his options. The amount of the benefit, that is, the spread between the option price and the market value, depended on when he chose to exercise his options and what the market value of the stock happened to be at that time. Often the option period is as much as ten years. In view of the many factors which determine the fluctuating value of stock, a case in which the benefits received match the value of services would be highly fortuitous. In fact, the benefit received by LoBue was substantially greater than his annual fixed salary although, as the Tax Court found, the nature and extent of his duties remained the same throughout his employment. (22 T. C. 440)

It is obvious that where employees are required to invest their own funds in order to procure the benefits of a stock

purchase plan, some will invest the full amount permitted, others only a part, and others nothing. *Ray A. Noland*, 12 T. C. M. 1003 (1953), involved the stock option plan of Trans World Airlines. The Tax Court held that the benefit received by pilot Noland was compensation, observing at page 1004:

> "Some TWA pilots purchased stock under the plan while others did not. The pilots who purchased stock, and others who did not, flew the same flights, did substantially the same amount of work and were paid the same rates of compensation."

The court below would require proof that employees who elected to buy no stock contributed nothing that would have entitled them to benefits under the plan.

The court below has sought to bolster its conclusion by stating that, if there were doubt as to whether the payments were dividends, Reynolds' historical treatment of them "should certainly remove it." (Opinion, App. 10) Suffice it to say that (1) the purpose of the payments made them "plainly compensation" irrespective of historical treatment; (2) the court's own findings show that except for tax purposes the treatment of the payments overwhelmingly indicates that they were compensation; and (3) the treatment for tax purposes was a mistake of law which in no way estops the partial recovery here sought.

The prior tax treatment of the payments resulted from an early ruling by the Bureau of Internal Revenue. (Findings 78, 81) Contrary to the implication in the opinion below (App. 10), such treatment resulted in the payment in every year of more taxes by Reynolds, and by Reynolds and its employees combined, than would have been paid had the payments been treated as compensation. Reynolds began deducting the payments in its tax returns in 1949

when the Bureau ruled that the payments under the bylaw as amended that year were compensation. Two years later, after the instant claims for refund were filed, that ruling was revoked. (Opinion, App. 6-7; Findings 71-4) In the companion *Reynolds* case for 1949 and 1950 the Tax Court stated in regard to the prior tax treatment (15 T. C. M. at 836):

> "But it is fundamental that the petitioner's conception or view of the situation, if it were erroneous at any time in the past, would not preclude it from establishing here the real nature of the distributions for tax purposes."

The case before the Tax Court cannot be distinguished on any tenable ground. There the court followed the *LoBue* principle, citing the decision, and held that the purpose of the payments was determinative of their nature, stating (15 T. C. M. at 836, 838):

> "We think the record sufficiently bears out the contention of petitioner that it was petitioner's intention at the inception of and throughout the operation of the by-law plan to encourage selected employees to invest in the stock of petitioner in order that they might be more closely identified with the company and be spurred to serve the company to a greater capacity. (Such is often the purpose and effect of a stock bonus, stock purchase plan or stock option plan, each of which may likewise be compensatory in nature.)
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> * * * * * *
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> In sum, the payments made to petitioner's employees under a plan, the origin and history of which indicate an attempt to further compensate worthy employees and to thereby secure their continued loyalty and efficient efforts, which plan has been largely successful and has contributed materially to the success of the petitioner, are to be con-

sidered compensatory in nature and deductible to the extent that they are demonstrated to be reasonable in amount."

As matters now stand, there is a direct conflict between the court below and the Tax Court in the case of the same taxpayer. The conflict should be resolved. If *LoBue* is controlling authority, the Tax Court presumably would be sustained on an appeal to the Court of Appeals for the Fourth Circuit. As stated above (p. 7), such an appeal cannot be taken until the decision in this case becomes final. Justice requires that resolution of the conflict not await action by the Court of Appeals, for by then the time for review of the decision below will have expired. The resulting injustice is obvious. See *United States* v. *Ohio Power Co.*, 353 U. S. 98 (1957).

2. Reasonableness of Payments.

Section 23(a)(1)(A) includes among deductible business expenses a "reasonable allowance" for compensation for personal services.

The Commissioner of Internal Revenue has made no determination on the reasonableness issue to which any presumption of correctness might attach. The Court of Claims made no finding that any payment was excessive but reached the sweeping negative conclusion that no payment was proved reasonable. This conclusion is a clear error of law in conflict with decisions of Courts of Appeal.

To summarize: (1) The court did not in fact assume *arguendo*, as stated, that the payments were compensation but persisted in its view that they were at least in part dividends, thus permitting the error on the first issue to vitiate the consideration of reasonableness. (2) The conclusion that no payment was proved reasonable is unten-

able in the face of substantial evidence of reasonableness, including unimpeached testimony, and the failure of the Government to introduce any evidence to prove unreasonable compensation.

At the outset of its discussion of the issue of reasonableness the court stated (Opinion, App. 12):

> "It is impossible, on the record before us, to determine * * * the number of shares of stock that were purchased without company approval and by whom. We cannot make a determination of the amount of refund the plaintiff is entitled to without proof of these facts."

Ultimate Finding 100 is to the same effect and Finding 97 states in the same context that the evidence "does not disclose the weight that should be given to stock holdings as distinguished from pure services". (See also Findings 95, 98.)

The relevant consideration was not the relation of the payments to stock but whether they were excessive in relation to the value of services. The court was preoccupied with, if not controlled by, the stock ownership method of measuring the amount of payments. Such preoccupation was quite inconsistent with the stated assumption (Opinion, App. 12) that the payments were compensation. If the court below had in truth assumed that the payments were compensation, it would have disregarded the manner in which stock was acquired and given no weight to stock holdings. It would have considered reasonableness on the premise that the payments were exactly like any other cash bonus contingent on annual profits.

If the payments are in fact treated as compensation, the unimpeached testimony and other evidence of record require a finding of reasonableness in the absence of any evidence of unreasonableness from the Government. The

decision below conflicts with *Baltimore Dairy Lunch, Inc.*, v. *United States*, 231 F. 2d 870 (C. A. 8th Cir. 1956), *Loesch & Green Const. Co.* v. *Commissioner*, 211 F. 2d 210 (C. A. 6th Cir. 1954), *Indialantic, Inc.*, v. *Commissioner*, 216 F. 2d 203 (C. A. 6th Cir. 1954), *Mayson Mfg. Co.* v. *Commissioner*, 178 F. 2d 115 (C. A. 6th Cir. 1949), *Wright-Bernet, Inc.*, v. *Commissioner*, 172 F. 2d 343 (C. A. 6th Cir. 1949), *R. P. Farnsworth & Co.* v. *Commissioner*, 203 F. 2d 490 (C. A. 5th Cir. 1953), and *J. H. Robinson Truck Lines, Inc.*, v. *Commissioner*, 183 F. 2d 739 (C. A. 5th Cir. 1950).[4] The court below in effect recognized the conflict by its reference to these cases "which seem in point and which caused the court considerable hesitancy". (Opinion, App. 13)

The most recent of these decisions, *Baltimore Dairy Lunch*, is representative. There the Revenue authorities had allowed as reasonable compensation for the taxpayer's treasurer and general manager $7,600 of the claimed $16,621.68. The taxpayer in its suit for refund relied principally on testimony to prove the reasonableness of the full amount claimed. The district court dismissed (121 F. Supp. 357). In reversing, the Court of Appeals for the Eighth Circuit first stated the following general principles regarding review of a lower court's finding (231 F. 2d at 871):

> "The fact that an appellate court might reach a different conclusion on disputed facts is not suffi-

[4] Apparently contrary decisions are distinguishable because they involved opinion testimony which was impeached, inherently improbable, or inconsistent with other substantial evidence. *E.g. Golden Const. Co.* v. *Commissioner*, 228 F. 2d 637, 639 (C. A. 10th Cir. 1955); *R. H. Oswald Co.* v. *Commissioner*, 185 F. 2d 6, 9 (C. A. 7th Cir. 1950), *cert. denied* 340 U. S. 953 (1951). See also *Dayton Power & Light Co.* v. *Commissioner*, 292 U. S. 290 (1934) (leasehold valuations for rate-making purposes), where three opinions of value were rejected because widely divergent, based on the erroneous premise of a free market, and inconsistent with other evidence.

cient reason for reversal. A judgment is clearly erroneous when there is no substantial evidence to support it, when it is against the clear weight of the evidence, or when it is induced by an erroneous view of the law. Pendergrass *v.* New York Life Ins. Co., 8 Cir., 181 F. 2d 136, and cases cited therein. In United States *v.* United States Gypsum Co., 333 U. S. 364, at page 395, 68 S. Ct. 525, at page 542, 92 L. Ed. 746, the finding of the trial court was found to be clearly erroneous, the Supreme Court stating:

> "* * * A finding is "clearly erroneous" when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.'

See also Universal Camera Corp. *v.* N. L. R. B., 340 U. S. 474, 71 S. Ct. 456, 95 L. Ed. 456."

The Court of Appeals then reviewed the evidence of record, noting in particular that the opinion testimony of Owens, the employee involved, on reasonableness was uncontradicted and that the trial court had not expressed disbelief (*id.* at 874). The court concluded (*id.* at 875):

> "Whether Owens established his right to the full $16,621.68 claimed is a question open to greater difficulty. There is, however, evidence to support such a claim. The taxpayer has by its evidence met the burden of overcoming the presumption of correctness of the Commissioner's finding. The Government has introduced no substantial evidence to show that the salary deduction claimed by taxpayer is unreasonable. Under such circumstances the decision of the trial court is clearly erroneous. R. P. Farnsworth & Co., Inc., *v.* Commissioner, 5 Cir., 203 F. 2d 490; Mayson Mfg. Co. *v.* Commissioner, 6 Cir.,

178 F. 2d 115; J. H. Robinson Truck Lines, Inc., *v.* Commissioner, 5 Cir., 183 F. 2d 739; Wright-Bernet, Inc., *v.* Commissioner, 6 Cir., 172 F. 2d 343. In the Mayson Mfg. Co. case the court quotes with approval from Taylor & Co. *v.* Glenn, D. C. W. D. Ky., 62 F. Supp. 495, 499, the following language, 178 F. 2d at page 121:

> "• • • "If the compensation received • • • was unreasonable for the services rendered, certainly the government could have produced some experienced witness • • • who would have said so. The lack of such evidence operates very strongly against the defendant's contention." ' ' '"

There is extensive testimony in the case at bar supporting the reasonableness of payments to the individual employees. It was based on "the usual factors that enter into an appraisal of the value of an employee's services". (Finding 101) The court stated that the testimony "must be given some weight, especially since the witnesses were in no way impeached". The Government offered no evidence to refute the testimony or to prove unreasonable compensation. The stated reason for the court's not considering the testimony "conclusive" is that "the witnesses, in arriving at their conclusions, did not make an adequate comparison of the wage scales of comparable jobs in other companies of the tobacco industry." (Opinion, App. 13) This reason is untenable both on the law and on the facts.

Comparative evidence, while it may at times be helpful, is not an essential element of proof of reasonableness. In *Mayson Mfg. Co., supra,* the Court of Appeals for the Sixth Circuit reversed the Tax Court on the express ground that "the absence of such [comparative] testimony, from both petitioner and respondent, has little bearing on the issue" (178 F. 2d at 121). To the same effect see *Drilling and*

Service, Inc., 15 T. C. M. 1417, 1424 (1956); *Faucette Co.*, 17 T. C. 187, 196 (1951); and 4 Mertens, Law of Federal Income Taxation, § 25.72, p. 171 (1954). See also *Miller Mfg. Co.* v. *Commissioner*, 149 F. 2d 421, 424 (C. A. 4th Cir. 1945).

To the extent that wage comparisons would be helpful, this record contains evidence on which the court has based express findings. Most of the Reynolds employees worked in the Winston-Salem area where there were no comparable tobacco companies. Hence, comparative wage scales in the industry would have little or no evidentiary value even if they could have been obtained. More significant are the local wage rates and the court has found that the Reynolds wages were at or below the going rate in the community. (Finding 66; Opinion, App. 5) The leaf buyers and salesmen worked over wide territories in direct competition with competitors. As to these the court found that "The fixed salaries paid by plaintiff to its buyers and salesmen were low in comparison to competitors'." (Opinion, App. 5, 6)

With respect to the executive officers the court states that the comparative evidence "related only to the aggregate compensation of the group". (Opinion, App. 14) This is a clear misstatement. Finding 90 sets forth in parallel columns the annual compensation of the "individual officers and directors of plaintiff, American, Liggett and Lorillard".

While conceding the comparative evidence tended to prove that the total compensation of the executive group was not out of line with competitors, the court held it insufficient as to individuals because there was no proof of "comparative duties and responsibilities of the individual officers" of competitors. (Opinion, App. 14) Since comparative evidence is not necessary, *a fortiori* proof of comparative duties and responsibilities is not necessary. *J. H.*

Robinson Truck Lines v. *Commissioner*, 183 F. 2d 739, 740 (1950), *rev'g* 8 T. C. M. 892, 894; *R. P. Farnsworth* v. *Commissioner*, 203 F. 2d 490, 492 (1953), *rev'g* 10 T. C. M. 1181, 1203.

In *Cullers* v. *Commissioner*, 237 F. 2d 611, 616-7 (C. A. 8th Cir. 1956), involving the valuation of real property for gift tax purposes, the Court of Appeals reversed the Tax Court for arbitrarily disregarding competent testimony on grounds which were unsound and for substituting its own judgment which was supported by no substantial evidence. The Tax Court had found a value intermediate between the values claimed by the taxpayer and the Government. In the case at bar the Court of Claims has found that no amount was proved reasonable.

Ultimate Finding 101 contains the startling statement that it cannot be determined from the evidence that the payments were "reasonable as to each and every individual officer and employee for the years 1940 to 1948, inclusive." This appears to mean that the present refund suit is an all or nothing proposition. To the contrary, Reynolds is entitled to recovery to the extent that the evidence proves reasonableness in any individual cases.

Many of the payments were so small that they were patently within the bounds of reasonableness. For example, of the 17,000 individual payments some 6,900 were less than $100 per year. These were not limited to hourly paid workers but included leaf buyers, salesmen, foremen, and others holding supervisory or managerial positions. Many of these payments were less than $50 per year. If any proof be needed to establish the reasonableness of payments such as these, surely evidence which "must be given some weight" suffices.

WHEREFORE, it is prayed that a writ of certiorari issue for review by this Court of the judgment below.

Respectfully submitted,

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PHILIP C. POTTER, JR.,
Counsel for Petitioner.

New York, N. Y.
October 8, 1957

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JOHN T. FEY, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1957.

No. 535

R. J. REYNOLDS TOBACCO COMPANY,
Petitioner,

v.

THE UNITED STATES,
Respondent.

APPENDIX
TO
PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS.

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New York, N. Y.,
October 8, 1957.

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In the United States Court of Claims

No. 254-54.

(Decided April 3, 1957.)

R. J. REYNOLDS TOBACCO COMPANY *v.* THE UNITED STATES.

Mr. MARION N. FISHER for the plaintiff. Mr. LEON L. RICE, JR., Mr. W. P. SANDRIDGE, Mr. PHILIP C. POTTER, JR., Messrs. DAVIS, POLK, WARDWELL, SUNDERLAND & KIENDL, and Messrs. WOMBLE, CARLYLE, SANDRIDGE & RICE were on the briefs.

Mr. HOMER R. MILLER, with whom was Mr. Assistant Attorney General CHARLES K. RICE, for the defendant. Mr. ANDREW D. SHARPE and Mr. THOMAS HOGAN were on the brief.

Opinion.

LARAMORE, *Judge*, delivered the opinion of the court:

This action is brought to recover income and excess profits taxes allegedly improperly assessed against plaintiff for the years 1940 to 1948, inclusive, in the amount of $8,352,851.83, plus interest.[1]

The issue in the case is whether certain payments made by the plaintiff to its employees pursuant to a company bylaw passed in 1912 and paid proportionate to the employees' stockholdings in the company constitute compensation and are, therefore, deductible in arriving at taxable income. If the payments are considered compensation, they are deductible to the extent reasonable pursuant to section 23(a)-(1)(A) of the Internal Revenue Code of

[1] Subsequent to the filing of the suit with this court the plaintiff has conceded that $1,320,697.90 of previously claimed deductions are improper. The claim for refund is, therefore, altered to the extent that that amount would affect the overall tax liability.

1939. If the payments are not considered compensation, the question is whether the payments are otherwise ordinary and necessary expenses of the business. If not, they represent distributions of capital and are disallowable expenses in arriving at taxable income.

There is also the subsidiary question as to the nature of payments purportedly made pursuant to the above mentioned bylaw by plaintiff to the employees of a wholly owned subsidiary, the Glenn Tobacco Company. This will be discussed separately later in the opinion.

The Commissioner of Internal Revenue disallowed all of the above payments as deductions for tax purposes contending that they were preferential dividends. The defendant before this court reiterates the Commissioner's position contending that no part of the payments are deductible. Defendant argues that the purpose of the bylaw was to encourage the employees to acquire a proprietary interest in the company and thereby acquire voting control. Such a purpose, it contends, would necessarily defeat the alleged compensatory nature of the payments. Defendant also points to the historical treatment of the bylaw payments by the plaintiff on its books and tax returns as dividends as establishing that the payments are dividends and argues that on the basis of equitable estoppel it cannot now assert that the payments were compensatory in nature.

Plaintiff alleges that all sums of money paid pursuant to the bylaw, with the exception of certain sums now conceded by it to have been excessive, were compensation to the employees for services rendered. Plaintiff supports its contention by alleging that the purpose of the bylaw payment plan was to create incentive in the employees and to cause them to work harder for the company. The necessary result would be, it contends, that any amounts paid would be for services rendered, hence, deductible in arriving at taxable income.

Plaintiff also contends that payments made by it, allegedly pursuant to the bylaw, to the employees of its subsidiary are part of its cost of goods sold arguing that since the entire function of that subsidiary was to purchase

foreign leaf tobaccos for it, any payments made to the employees of the company are a necessary element of the cost of the goods acquired by that company for the plaintiff.

The pertinent facts of the case may be stated as follows: On August 23, 1912, the plaintiff corporation passed a bylaw providing for a distribution of the company's annual profits in excess of a base figure computed at 22.19 percent of the outstanding common stock in an amount up to but not exceeding 10 percent of the profits in excess of such base figure. The distribution was to be to employees who had been in plaintiff's employ and held its stock for not less than 12 months with the distribution to be in proportion to the stockholdings of the employee. The bylaw was amended in 1915, the amendment permitting stock purchased from another officer or employee or from the personal representative of a deceased officer or employee to participate if the stock so purchased would have entitled the former owner to participate had it been held for the entire 12-month period. The bylaw was not substantially changed thereafter until 1949 and is the same bylaw that was in effect during the period in question, 1940 through 1948.[2] From 1912 through 1948 the plaintiff had an unbroken record of paying dividends on all of its outstanding stock. It likewise made distributions under the above bylaw every year through 1948, and thereafter, to the eligible employees.

Since 1922, when the Glenn Tobacco Company, a wholly owned subsidiary of plaintiff, was organized, the employees of that company who owned common stock of plaintiff have participated under the bylaw notwithstanding the fact that the bylaw makes no reference to them. The Glenn Company was engaged exclusively in the purchase of leaf tobacco in foreign countries for plaintiff and filed separate income tax returns. Plaintiff furnished it with all funds on open account to cover all the expenses and costs of acquiring foreign leaf tobaccos during the years in question.

[2] For the substance of the changes in the bylaw by the 1949 amendment, see finding 71.

It was plaintiff's intention when the bylaw profit distribution plan was set up in 1912 that it would provide its employees with a greater incentive, the feeling being that they would be more likely to take the company to heart if they owned stock in it.

As originally planned, the plaintiff wanted only those employees "who had the interest of the company at heart" to participate and did not want any one employee to acquire an excessive amount of stock in relation to his value to the company and the job performed. The plan was supervised by a company committee with this in mind. It was the desire of plaintiff that the participating stock should not be acquired without company approval, but there was no corporate resolution concerning the manner or method under which acquisition could or would be made and no express directions to employees as to the amount of stock which they could acquire. The view of management that it should approve common stock acquisitions by employees was passed by word of mouth on an informal basis. Those employees could purchase the stock if they felt financially able and thereby share in subsequent distributions under the bylaw. Plaintiff's founder, R. J. Reynolds, in the early years of the plan, financed many purchases of the plaintiff's employees. Up until 1933, plaintiff itself extended substantial credit to its employees for the purchase of its stock; however, the loans by the company were restricted in amount to the book value of the stock and the stock was held as collateral. Until 1935, when Security Exchange Commission sanctions prohibited it, plaintiff bought its own stock for resale to its employees. The purchases were made from various sources, including nonemployee stockholders and officers or other employees upon their death or resignation.

Over the years, however, two imperfections developed in the plan. Some employees acquired too much stock and others did not acquire as much as was considered appropriate to the extent that their positions and records would have entitled them in the management's view. Employees sometimes acquired the eligible stock by gift, exchange,

inheritance, purchase from other employees and holders of the stock, or purchase on the Stock Exchange, without advance notice to the company. Sometimes excessive stock ownership came about as a result of the company having encouraged ownership by an individual whose prospects of future value to the company were misjudged. However, no employees were ever discharged for acquiring too much stock. Plaintiff's management felt that these imperfections in the practical operation of their plan did not affect the overall success of the plan through the years and, in fact, credited the plan as being a large factor in the growth of the company from the smallest of the four principal tobacco companies in 1912 to the second largest and with a proportionate increase in size since 1912 greater than any of the other companies. During the period in question, 1940 through 1948, plaintiff had a higher ratio of earnings to sales and of earnings to equity than did the others.

Fixed salaries and hourly wages paid to plaintiff's employees on the levels below directors, officers, and junior officers, and other key employees, were at the going rate in the community. Salaried employees did not have fixed salaries larger than comparable positions in the next four or five largest companies in Winston-Salem, North Carolina, the location of plaintiff's plant, and in the view of the employees themselves, the salaries were in many cases lower. The fixed salaries paid by plaintiff to its buyers and salesmen were low in comparison to competitors'. These two groups were particularly encouraged to invest in the stock and the large majority of them did so and thereby increased their total income.

There was no evidence relating to the duties of the various individual officers and directors, or the responsibilities of each, or the amounts the individual officers and directors of the other companies received as compensation. There was no evidence introduced by plaintiff as to the reasonableness of the payments made to the other employees other than the testimony of four of the plaintiff's executives to the extent that they completely reviewed the records of all

the participating employees for the years in question and determined that all bylaw payments to them were reasonable with the exception of certain sums conceded to have constituted unreasonable compensation for the services performed. In arriving at this determination of reasonableness, plaintiff's executives took into consideration the employee's fixed salary and bylaw payments in relation to his ability, performance in the job, responsibility, length of service, and prospective value to the Company. No evidence as to the total compensation paid to employees in like jobs in similar companies was introduced, and no such comparison was attempted. The defendant did not introduce any evidence tending to prove unreasonableness of the payments if considered compensation, nor did it attempt to refute the above testimony of reasonableness of the payments with the conceded exceptions. The defendant steadfastly maintained that the payments were preferential dividends.

There is little doubt that plaintiff's purchasing, sales, and management personnel were highly efficient, as studies by a competitor disclosed that plaintiff often bought its tobacco at the auction markets very close to the "floor" price,[3] and that plaintiff's cost of manufacturing cigarettes was from three to five cents lower per thousand than that of its competitors. Testimony by the former president of this competitor, the Brown & Williamson Tobacco Corporation, indicated that the fixed salaries paid to plaintiff's sales and purchasing personnel were low in comparison to other companies.

The refunds sought in this suit were initially requested on March 13, 1950, when plaintiff filed with the Commissioner of Internal Revenue claims for refund, those claims being filed only after a determination by the Deputy Commissioner of Internal Revenue, on December 28, 1949, pursuant to a written request by plaintiff, that payments made by it

[3] The "floor" price represents that price placed on the various grades of tobacco plus one cent. To illustrate, if the government grader has placed a price of 40 cents on a particular grade, unless that tobacco is bid in at 41 cents, it reverts to the Government pool and the Government pays the farmer.

pursuant to its 1949 amended bylaw would constitute compensation for personal services rendered and, therefore, would be deductible to the extent reasonable. The above ruling, however, was revoked by letter to plaintiff on November 13, 1951, on the ground that the changes in the bylaw effected by the 1949 amendment "were not material to the question presented." The claims for refund were thus denied on July 9, 1952, pursuant to the 1951 letter revoking the 1949 ruling.

The plaintiff claims refunds of income and excess-profits taxes for certain years which would result by the deduction from income of certain profit-sharing dividends paid to employees who owned shares of the corporation. The plaintiff contends that such dividends were, in effect, additional compensation to employees.

At the outset we must determine whether the sums paid under the bylaw are reasonable compensation or some sort of preferential dividend, for any payment made by an employer to its employees, to be deductible as compensation, must have been paid for services actually rendered. *William S. Gray & Co.* v. *United States*, 68 C. Cls. 480; *Woodcliff Silk Mills* v. *Commissioner*, 1 B. T. A. 715.

To determine whether the payments in the case at bar were compensation or dividends, we must look to the bylaw under which the payments were made, and its history, together with the section of the Internal Revenue Code of 1939 under which plaintiff claims relief.

The bylaw proposed by the board of directors and adopted on August 23, 1912, provided as follows:

> Participation by Officers and Employees in Certain Profits
>
> All of the Company's Officers and Employees who have owned its stock and been in its employ for not less than twelve months, may be allowed, in the discretion and at the option of the Board of Directors, beginning with the year 1912, to participate, in proportion to the stock thus owned, in the Company's Annual Profits

which are in excess of the percentage of profits earned during the year 1910, to-wit: 22.19%, not exceeding, however, 10% of those profits, in excess of 22.19% of its entire outstanding issue of common stock, taking into account pro rata, any increase or decrease thereof, made during the year.

In 1915 the bylaw was amended as follows:

Participation by Officers and Employees in Certain Profits

All of the Company's officers and employees who have owned its Common Stock and been in its employ for not less than twelve months, then next preceding may be allowed, in the discretion and at the option of the Board of Directors, beginning with the year 1912, to participate in proportion to the Common Stock thus owned, in the Company's annual profits which are in excess of the percentage of profits earned during the year 1910, to wit: 22.19%, not exceeding, however, 10% of those profits in excess of 22.19% of its entire outstanding issue of Common Stock, taking into account pro rata any increase or decrease thereof made during the year. The Common Stock owned by an officer or employee, for the purpose of this By-Law, beginning with the year 1916, shall include any stock purchased during the year from an officer or employee or from the personal representative of a deceased officer or employee, provided such stock would have entitled the former owner to participate in proportion thereto had it been held for the entire 12 months' period.

Thereafter, the bylaw remained in effect until it was again amended in 1949. It is for the period before the 1949 amendment that plaintiff here claims.

The profit-sharing plan was adopted by stockholders of the corporation in 1912. The purpose of the plan was obviously to encourage employees to become owners of a

share of the business, and, by reason of such ownership, would have a greater interest in its profitable operations and would give their best efforts to this end. The plan provided that such employee owners would not only share equally with other stockholders in regular dividend distributions, but would receive special profit-sharing distributions from profits which would result from the greater interest of workers.

The basis of distribution of the profit-sharing dividends was pro rata to the number of shares held by all employees and in proportion to the number of shares held by each, without regard to the position held or services rendered. In order to construe such distributions as increased compensation for services rendered it must be found that the employee holding the greatest number of shares contributed the most valuable service, or that such employee was previously underpaid for the work he had performed, or that other employees who purchased no shares, contributed nothing to the increased profits from which such dividends were distributable. This has not been proved.

In plaintiff's plan, employment as well as investment by the employee was necessary before participation was possible. The defendant contends that this requirement of investment before participation affixes the label of dividends to payments under the bylaw. In other words, the payments came about as a result of the employee's investment and not because of services rendered. Thus, defendant argues that the payments in no way take on the character of compensation for services rendered so as to be deductible as ordinary and necessary business expense under section 23(a)(1)(A) of the 1939 Internal Revenue Code, which provides in part, as follows:

> *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; • • •

We agree with defendant's contention.

Bearing in mind that the bylaw adopted by plaintiff was prior to the enactment of the income tax laws, we cannot say that the plan was not designed to incite greater efforts on the part of its employees because of investment in the company. Further, we cannot say that the plan was designed for tax avoidance. However, conceding that the plan was designed for incentive purposes, the payments must have been reasonable compensation and not dividends in order to be deductible under section 23(a)(1)(A) of the Internal Revenue Code of 1939 because the two were mutually exclusive.

The payments are the very essence of dividends; *i. e.*, distribution of the company's earnings made by the directors in their discretion and in direct proportion to stock holdings. Even if there were doubt as to whether the payments were dividends, the treatment of them by plaintiff should certainly remove it.

Historically, plaintiff treated the bylaw payments as dividends as is evidenced by the following facts of record: In tax matters generally the taxpayer treated the payments as dividends. In its return for 1940 to 1948, inclusive, the taxpayer never claimed the payments as deductions for any purposes; payments were not claimed or allowed for deductions in determining taxpayer's base in the years 1936 to 1939, inclusive, for excess-profits tax purposes; in computing its undistributed profits tax for 1936 to 1939 inclusive, taxpayer claimed that the payments were dividends and received substantial tax benefits thereby; taxpayer did not claim the payments as deductions in its State income tax returns; by and large the payments were shown as unallowable deductions or nondeductible items on the tax returns; the treatment of the items by taxpayer was approved by taxpayer's auditors as being in conformity with generally accepted accounting principles; in computing its social security and withholding taxes the payments were not treated by taxpayer as compensation; in 1942 taxpayer applied to the Commissioner for a ruling as to whether the payments should be treated as compensation in determin-

ing whether they could be properly made under salary stabilization laws and regulations, and stated that the payments had consistently been treated as dividends. The Commissioner so ruled; in filing forms 10-K with the Securities and Exchange Commission for the years 1946 to 1948 inclusive, plaintiff referred to the payments as dividends; plaintiff's retirement plans, adopted in 1929 and 1946, defined the terms "wage" and "compensation" so as to exclude bylaw payments for purposes of computing pensions; plaintiff's explanatory letter of August 8, 1912, stated that the payments were to be in proportion to stock *bona fide* owned by officers and employees of taxpayer; the payments were always in exact proportion to the common stock owned by the employee and were in addition to fixed compensation, regardless of the duties and responsibilities of the employee; plaintiff has admitted that under the plan large amounts sued for in the petition could not possibly be treated as reasonable compensation; fixed salaries and hourly wages to employees below directors and officers were at the going rate in the community. When plaintiff gave across-the-board pay increases to hourly workers and supervisory personnel it did so without regard to stock ownership. The resolution of taxpayer's board for 1940 to 1945 referred to the payments as "participating dividends"; in the case of *Bookman* v. *R. J. Reynolds Tobacco Co.*, 138 N. J. Eq. 312, 48 A. 2d 646, taxpayer in its answer alleged that the payments were dividends, and the court so held.

The taxpayer in order to recover is required to establish that it overpaid its taxes, which necessitates in this case a showing that the sums in question are deductible under section 23(a)(1)(A). Section 23(a)(1)(A) provides for allowance as deductions all of the ordinary and necessary expenses paid or incurred, "including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *."

Section 29.23(a)(6), Treasury Regulation 111, governing the years 1942 to 1948, inclusive, provides that in order to be deductible as compensation or as ordinary and necessary business expense, the payments must not only be

reasonable but be based purely on services rendered. Treasury Regulation 103, section 19.23(a)(6), governing the years 1940 and 1941, are similar.

The evidence here discloses, and the Commissioner of this court has found, that the payments to employees were because of their investment in stock and not purely for services.

Since the payments were because of investment in stock and not purely for services, said payments would be dividends and not compensation. *Twin City Tile & Marble Co.* v. *Commissioner*, 6 B. T. A. 1238, aff'd 32 F. 2d 229.

It necessarily follows that were the payments not classified as compensation, they were clearly not business expenses.

The amounts paid by the corporation to its employees, having no substantial relation to the measure of their services and being utterly disproportionate to their value, are not in reality payment for services and cannot be regarded as "ordinary and necessary expenses" within the meaning of section 23(a)(1)(A), *supra*. *Botany Worsted Mills* v. *United States*, 278 U. S. 282, 292.

Assuming, *arguendo*, that the bylaw payments fell within the scope of section 23(a)(1)(A) of the 1939 Internal Revenue Code and were deductible as ordinary and necessary business expenses, the plaintiff would fail here for still another reason. To the extent that the payments represent unreasonable compensation for the services performed, they cannot be deducted by plaintiff for income tax purposes.

It is impossible, on the record before us, to determine just how much of the payments represents reasonable compensation or the number of shares of stock that were purchased without company approval and by whom. We cannot make a determination of the amount of refund the plaintiff is entitled to without proof of these facts.

Plaintiff urges that the unrefuted testimony of its four executives to the effect that all of the payments, with certain designated exceptions, were reasonable compensation for the services performed by the various employees is suffi-

cient to prove its case on the issue of reasonableness since the testimony was by men long acquainted with the tobacco industry, thus were experts, and since the testimony came only after a thorough analysis and study of the records of all the participating employees, and especially so since the integrity of these witnesses was not seriously questioned. The plaintiff notes that the defendant offered no testimony or documentary evidence to refute their testimony and, therefore, contends that it, the plaintiff, must be deemed to have proven its case and that the defendant failed in refuting such proof.

As hereinbefore noted, the above referred to witnesses testified that they reviewed the records of *all* participating employees, including officers and directors, and determined that, except for certain specified amount, all payments made pursuant to the bylaw, when added to the fixed wages of the individual employees, did not exceed reasonable compensation for the services performed. In making this determination, the witnesses took into consideration the participating employee's ability, performance in the job, responsibility, length of service, and prospective individual value to the company.

The plaintiff in making its argument that this testimony proves its case as to reasonableness, notwithstanding the fact that it came from witnesses who were undoubtedly biased to some degree, cites several cases which seem in point and which caused the court considerable hesitancy before finally deciding that, while such testimony must be given some weight, especially since the witnesses were in no way impeached, it cannot be conclusive on the question of reasonableness. We cannot consider it conclusive because the witnesses, in arriving at their conclusions, did not make an adequate comparison of the wage scales of comparable jobs in other companies of the tobacco industry.

Plaintiff further asserts that the reasonableness of the total compensation paid to the officer-director group was definitely proved because the total compensation paid the group compared favorably with that of plaintiff's three leading competitors and that there was testimony to this

effect as well as written computations. The court, however, must disagree. The testimony and comparisons related only to the aggregate compensation of the group as compared to the aggregate compensation of a similar group of the other companies. There was no direct comparison with competitors by showing comparative duties and responsibilities of the individual officers or directors. The proof was based solely on a comparison of the total wages paid the officer-director groups of the respective companies in proportion to sales and earnings of those companies.

While such evidence may tend to prove that the total compensation of the officer-director group is not out of line with the total compensation paid to a like group by competitors, it is insufficient to prove the reasonableness of the compensation paid to any individual officer or director. Since there was no comparison of the duties or responsibilities of individuals doing like jobs, we must hold that the evidence is insufficient to prove the reasonableness of the total compensation received by the individual officers or directors of plaintiff. See *L. Schepp Company* v. *Commissioner*, 25 B. T. A. 419; *L. E. Pinkham Med. Co.* v. *Commissioner*, 128 F. 2d 986, *cert. denied*, 317 U. S. 675 (1942). The situation was adequately explained in the Schepp case, *supra* at 429-430, wherein the court stated as follows:

> • • • To test the salary deduction by ascertaining the ratio of the aggregate salaries to net earnings or gross sales would result in the recognition of a mathematical gross maximum and either the disregard within that figure of any relation between individual service and the compensation therefor, however plainly disproportionate, or else the consideration of the sum of all services and the relation of the whole to the gross salaries paid. This would practically nullify the clear statutory language and be at variance with the judicial tests laid down in the decisions above set forth. While it might superficially appear that the total paid to all four of petitioner's officers is small in comparison to its gross sales and net earnings, it does not appear that

the amount credited to Florence Schepp is reasonable in comparison to her service. There is no evidence whatever of services and salaries actually performed and paid by and to other individuals in the same or comparable businesses, and no evidence of how much the company would have to pay to get someone else to do what Florence Schepp did.

The foregoing being so, we must hold that the plaintiff has not sufficiently proven its case on reasonableness, notwithstanding the fact that defendant has offered no evidence to refute that of the plaintiff's in this respect.

We think it would be proper to note at this time that we are not unmindful of the tax court decision in *R. J. Reynolds Tobacco Company* v. *Commissioner*, T. C. Memo 1956–161, decided July 6, 1956, in which that court decided that part of the bylaw payments for the years 1949 and 1950 were reasonable compensation and devised a formula to determine just what part of the payments represented reasonable compensation. However, the court in that case was deciding the nature of the payments made pursuant to a different bylaw, on a different record, and for different years than the ones in question here.

The tax court carefully pointed out in its opinion that the taxpayer prior to 1949 had a "shifting point of view," but that since then its attitude as to the nature of the distribution has been constant. The tax court then devised a formula from the record before it and permitted recovery by taxpayer. This court cannot, on the record before us, devise any formula such as the tax court has. We must look to the proof in this case, and we find a complete failure on the part of plaintiff in its proof of reasonableness.

The only remaining problem is whether payments made by plaintiff to the employees of its subsidiary, the Glenn Tobacco Company, are deductible as part of the cost of goods sold. We find no trouble in holding that no part of the amounts paid to the employees of Glenn are deductible either as compensation or as part of the cost of goods sold for the very simple reason that Glenn's employees were not

qualified to receive anything under the bylaw which limited participation under the plan to the "Company's officers and employees who have owned its Common Stock and been in its employ for not less than twelve months, * * *." Plaintiff's board of directors was without authority to compensate another company's employees. We cannot hold that sums of money paid by a company's board of directors without authority are deductible for tax purposes on any theory.

It is therefore concluded that the payments made by plaintiff were preferential dividends and not compensation such as would be deductible under the Revenue Code of 1939, *supra*.

Plaintiff's petition is, therefore, dismissed.

MADDEN, *Judge;* and LITTLETON, *Judge*, concur.

WHITAKER, *Judge*, concurring:

I agree that the payments to employees under the plan of the bylaw are not deductible as compensation for services rendered, because the payments were made in proportion to stock ownership and not in relation to the value of services rendered.

I would not decide the question of reasonableness.

JONES, *Chief Judge*, joins in the foregoing concurring opinion.

Findings of Fact.

The court, having considered the evidence, the briefs and argument of counsel, and the report of Commissioner Marion T. Bennett, makes the following findings of fact:

1. Plaintiff, R. J. Reynolds Tobacco Company, is a corporation organized in 1899 under the laws of New Jersey. It is engaged in the business of buying leaf tobacco and processing and manufacturing it into tobacco products,

namely, cigarettes, smoking tobaccos and chewing tobaccos, and selling such products. Its executive offices and principal manufacturing plants are located in Winston-Salem, North Carolina. Its accounting year is the calendar year, and it keeps its books of accounts and files its income and excess-profits tax returns for calendar year periods and on the accrual basis of accounting.

2. Within the time required by law, plaintiff filed with the collector in North Carolina its corporation income tax returns and its excess-profits tax returns, for the years so required by law, disclosing the following amounts of taxes due for each of the years indicated:

Year	Income tax	Excess profits tax	Total
1940	$ 8,823,568.84	$23,534.99	$8,847,103.83
1941	12,310,574.01	4,737,687.64	17,048,261.65
1942	13,226,331.40	9,070,677.30	22,297,008.70
1943	13,200,971.06	2,610,909.96	15,811,881.02
1944	12,625,525.85		12,625,525.85
1945	13,519,460.52		13,519,460.52
1946 (amended return)	18,450,247.37		18,450,247.37
1947	21,395,339.42		21,395,339.42
1948	22,871,594.74		22,871,594.74
Total	136,423,613.21	16,442,809.89	152,866,423.10

The above amounts were paid to the collector by plaintiff on or about the statutory installment dates fixed by law and were accepted by the collector as having been duly paid. By reason of the amended return for 1946, showing a larger amount of tax due than on the original return, plaintiff paid interest in the amount of $1,583.27.

3. Subsequently, as a result of various adjustments affecting the income or excess-profits tax liabilities of plaintiff, which adjustments were agreed to by the Commissioner of Internal Revenue and plaintiff, the following deficiencies in tax were paid by plaintiff, and the following overassess-

ments of tax were credited or refunded to plaintiff for the years indicated:

Year	Kind of tax	Deficiency	Overassessment
1940	Income	$45,785.56	
	Excess profits	42,999.29	$12,202.04
1941	Income		727,916.00
	Excess profits	28,121.18	
1942	Income	600,276.55	
	Excess profits		1,273,052.06
1943	Income	507,881.35	85,648.15
	Excess profits	243,778.83	1,142,733.03
1944	Income	24,671.12	
1945	Income		40,997.40
1946	Income	8,989.53	
1947	Income	4,782.05	
1948	Income	24,082.66	

Postwar refunds of excess-profits tax were allowed as follows:

Year 1942	$779,762.52
Year 1943	171,195.58

4. Taking into account the taxes paid as set out in finding 2 and the adjustments set forth in finding 3, the adjusted total taxes paid were as follows for the years indicated:

Year	Kind of tax	Adjusted total, tax paid
1940	Income	$8,869,354.40
	Excess profits	54,332.24
1941	Income	11,582,658.01
	Excess profits	4,765,803.82
1942	Income	13,826,607.95
	Excess profits	7,797,625.24
	Postwar refund	(779,762.52)
1943	Income	13,623,204.26
	Excess profits	1,711,955.76
	Postwar refund	(171,195.58)
1944	Income	12,650,196.97
1945	Income	13,478,463.12
1946	Income	18,459,236.90
1947	Income	21,400,121.47
1948	Income	22,895,677.40
Total		150,164,284.44

5. On March 13, 1950, and within the time required by law, plaintiff filed with the collector its claims for refund of income and excess-profits taxes, including claims for statutory interest, for each of the years 1940 through 1948, as follows:

Year	Kind of tax	Amount of tax
1940	Income	$ 424,749.40
	Excess profits	11,332.95
1941	Income	967,492.44
	Excess profits	1,136,050.02
1942	Excess profits	3,922,388.21
1943	Excess profits	1,468,176.93
1944	Income	455,581.30
1945	Income	563,288.10
1946	Income	731,779.23
1947	Income	832,843.89
1948	Income	900,639.51
Total		11,414,321.98

The basis for each claim for refund was that payments made to employees under article XII of its bylaws, hereinafter generally called "the bylaw," were deductible or otherwise allowable in computing the net income of plaintiff for the taxable year covered by the claim. In its claims, plaintiff stated that such payments fell within one or more of the following categories:

(1) A reasonable allowance for compensation for personal services actually rendered, within the meaning of Section 23 (a) of the Internal Revenue Code;

(2) An ordinary and necessary business expense incurred during the taxable year in carrying on the business of the taxpayer, within the meaning of Section 23 (a) of the Internal Revenue Code;

(3) A part of the cost of goods sold by the taxpayer during the taxable year, in determining the gross income of the taxpayer under Section 22 (a) of

the Internal Revenue Code. See Reg. 111, Sec. 29.22 (a)–5.

Such payments were not claimed as deductions or as part of the cost of goods sold in its income tax returns or excess-profits tax returns for any of the years 1940 through 1948. Nor have such payments been allowed as deductions or as part of the cost of goods sold as a result of any adjustments heretofore made in determining the income tax or excess-profits tax liabilities of plaintiff for such years. Such payments were not claimed as deductions or as part of the cost of goods sold in plaintiff's income tax returns for the excess-profits tax base period years 1936 through 1939, nor have such payments been allowed as a result of any adjustments of such returns.

6. There are some discrepancies between the records of plaintiff and the district director regarding the dates of payments of the amounts set out above, which dates would become material in computing interest on refunds in the event it was held that plaintiff is entitled to recover anything in this action. The parties have stipulated that in case of a finding in favor of plaintiff, they will endeavor to reach an agreement as to the proper computations on the basis of the findings, such computations to be used as a basis for the judgment. If there are disagreements the disputed matters will be submitted to the court for determination.

7. As a result of events occurring after its claims for refund were filed, including the adjustments referred to in finding 3, and certain deficiencies in income tax for 1942 and 1943, which are admitted by plaintiff to be due if its claims for refunds of excess-profits tax for the same years are allowed, the tax refunds claimed in this suit by plaintiff are shown by the following schedule:

Year	Income tax refunds (deficiencies)	Excess profits tax refunds	Total income and excess profits tax refunds
1940	$461,371.74	$54,332.24	$515,703.98
1941	240,187.81	1,162,199.05	1,402,386.86
1942	(480,252.43)	2,135,063.01	1,654,810.58
1943	(228,615.52)	1,540,760.18	1,312,144.66
1944	480,252.42		480,252.42
1945	522,290.70		522,290.70
1946	731,779.23		731,779.23
1947	832,843.89		832,843.89
1948	900,639.51		900,639.51
Total	3,460,497.35	4,892,354.48	8,352,851.83

No part of such refunds claimed by plaintiff has been refunded, credited, set off, or otherwise allowed by defendant to plaintiff.

8. It has been stipulated that if the court finds and holds that plaintiff is entitled to recover all or part of the amounts sued for in this action, the parties will attempt to reach an agreement as to the amounts recoverable and, if they should so agree, they will file a stipulation with the court showing the amounts recoverable on the basis of the findings and conclusions of the court and in the event of a dispute the matter will be submitted to the court for determination.

9. The Commissioner of Internal Revenue, by registered letters under date of July 9, 1952, notified plaintiff that its claims for refund for each of the years 1940-1948 were disallowed in full.

10. The claims for refund and the disallowance thereof by the Commissioner of Internal Revenue constitute the basis of this suit. All conditions precedent to the maintenance of this suit by plaintiff have been performed or have occurred.

History of Plaintiff's Common Stocks

11. When the bylaw, described more fully hereafter, was adopted in 1912, plaintiff had only one class of stock outstanding, 75,250 shares of common stock, $100 par value. Later in 1912 it issued 24,750 additional shares. At the end of 1912, the common stock outstanding consisted of 100,000 shares, having an aggregate par value of $10,000,000. Up until the end of 1948, the only changes made in the common stock of plaintiff were a split of four shares for one, accompanying a reduction in the par value to $25 a share in 1920, and a further split of two and one-half shares for one, accompanying a reduction in par value to $10 a share in 1929. These reductions in par value increased the number of shares of common stock outstanding to one million, having an aggregate par value of $10,000,000.

12. In 1918, plaintiff issued a class B common stock, $100 par value, in the total amount of 100,000 shares, having an aggregate par value of $10,000,000. In 1920 each share of the class B common stock was exchanged for four shares of new class B common stock, $25 par value. The new class B common stock was also changed by a split of two and one-half shares for one, accompanying a reduction in par value to $10 in 1929. At times pertinent in this case, the new class B common stock had the same rights and privileges as the old common stock, sometimes hereafter referred to as class A common, except that it was not eligible for participation under the bylaw and it had no vote.

13. Stock dividends in the new class B common stock were distributed in 1920 to the holders of common stock and new class B common stock at the rate of 200 percent, in 1922 at the rate of 33⅓ percent and in 1927 at the rate of 25 percent.

14. As a result of these capital changes affecting the B common stocks, the new class B common stock outstanding during the years 1940-1948 consisted of 9,000,000 shares of

$10 par, an aggregate par value of $90,000,000. One million shares of class A common were outstanding during this same period.

15. The total amount of capital paid to plaintiff on account of its A common and B common stocks was $20,000,000, $10,000,000 with respect to the A common and $10,000,000 with respect to the B common.

16. Plaintiff never received any greater amount of paid-in capital on account of the common stock participating under the bylaw than it received with respect to common stocks of both classes not eligible for participation under the bylaw. Some common stocks of plaintiff during each of the years 1940-1948 were held by persons not eligible to participate under the bylaw.

17. The following schedule sets forth the number of A common and B common stockholders of plaintiff and the total of such stockholders for each of the years 1940 through 1948:

Year	A common	B common	Total
1940	2,380	59,676	62,056
1941	2,376	58,900	61,276
1942	2,371	58,183	60,554
1943	2,345	58,993	61,338
1944	2,366	59,290	61,656
1945	2,370	60,166	62,536
1946	2,334	60,441	62,775
1947	2,318	59,277	61,595
1948	2,404	58,636	61,040

History of Plaintiff's Bylaw and Competitors' Profit-Sharing Plans

18. The four principal tobacco companies which emerged from the dissolution of the so-called American Tobacco Company trust in 1911 as a result of the decision in *United States* v. *American Tobacco Company*, 221 U. S. 106, were

The American Tobacco Company, Liggett & Myers Tobacco Company, P. Lorillard Company (hereinafter called American, Liggett and Lorillard), and plaintiff.

19. In 1912, but prior to August of that year, American, Liggett and Lorillard adopted bylaws providing for participation in profits by certain of their officers. Each of these bylaws provided that beginning with 1912 ten percent of the annual net profits of the company in excess of a base amount, estimated as the net profits earned during 1910 by the part of the business belonging to each company after the dissolution of the tobacco trust, should be paid to the president and five vice presidents of the company in the proportion of one-fourth to the president and one-fifth of the remainder to each of the five vice presidents. The payments were denominated salary for the year in addition to the fixed salary of each of the officers. Lorillard adopted an additional bylaw providing for a distribution of five percent of its net profits, above the same base amount, among such employees other than the president and vice presidents, as the board of directors should determine and in the amounts determined by the board. None of these bylaws as originally adopted provided for participation in profits on the basis of stockholdings.

20. On August 2, 1912, plaintiff through its secretary, George W. Coan, addressed a circular letter to all of its stockholders, enclosing a notice calling a special meeting of stockholders to take action on a proposed bylaw. The first two paragraphs of the letter are as follows:

> After full consideration, the Board of Directors have determined that the interest of the Company and all of its stockholders will be materially advanced by encouraging its officers and employes, a number of whom are now stockholders, to invest in its stock and to be thus more closely identified with its affairs.
>
> To promote this cooperation, it is proposed that, beginning with the year 1912, all of the officers and

employes of the Company who have owned its stock and been in its employ for not less than twelve months be allowed, at the option of the Board of Directors, to participate, in proportion to the stock thus owned, in the annual profits, if any, earned by the Company, in excess of profits earned during the year 1910, not exceeding in the aggregate 10% of such excess.

20 The following is the text of a letter dated August 8, 1912, from R. J. Reynolds, president of plaintiff, to the stockholders, further explaining the proposed bylaw:

In answering a few of our stockholders, with reference to the plan for promoting the further cooperation of its officers and employes in advancing the interests of the Company and all of its stockholders, as set forth in recent notice of Stockholders' Meeting, to be held August 23rd, some of the questions that have been asked suggest information, given below, which other stockholders will doubtless be pleased to have.

The profits of the Company for the year 1910 were 22.19% of its $7,525,000 capital stock and were taken as a basis because the calculations on businesses and brands for 1910, as shown in the plan submitted to the Court by The American Tobacco Company and others, were, in effect, those upon which the dissolution was based. Profits for 1910 have likewise served as a basis upon which other companies interested in the dissolution have, this year, formulated and adopted By-Laws providing funds, not exceeding 10% of excess profits, for distribution among certain of their officers.

The proposed By-Law to be considered and acted upon by the stockholders will provide, in detail, that the funds for distribution among officers and employes holding stock must not exceed 10% of those profits of the Company which are in excess of 22.19% of its entire outstanding issue of common stock, taking into account the proposed new issue of $2,475,000, when made.

Employes, as well as officers, holding stock, will be allowed to participate in the funds to be created; but the distribution will only be made in proportion to that stock which has been bona fide owned by the officer or employe for one year prior to the date of distribution. This will be a check against speculation on the proposition and will also be an inducement for its valued officers and employes, 48 of whom are now stockholders, to become permanently interested in the Company as such.

22. The bylaw proposed by the board of directors of plaintiff was adopted at the special meeting of stockholders held on August 23, 1912. The number of shares of common stock, $100 par value, outstanding at the time of the meeting was 75,250. The number of shares represented in person and by proxy at the meeting was 45,423, all of which were voted in favor of the adoption of the bylaw. This bylaw, designated article XIII, provided as follows:

Participation by Officers and Employees in Certain Profits

All of the Company's Officers and Employees who have owned its stock and been in its employ for not less than twelve months, may be allowed, in the discretion and at the option of the Board of Directors, beginning with the year 1912, to participate, in proportion to the stock thus owned, in the Company's Annual Profits which are in excess of the percentage of profits earned during the year 1910, to-wit: 22.19%, not exceeding, however, 10% of those profits, in excess of 22.19% of its entire outstanding issue of common stock, taking into account pro rata, any increase or decrease thereof, made during the year.

23. In 1915, after a 1913 amendment of plaintiff's certificate of incorporation to authorize the issuance of preferred stock and the sale of some preferred stock in 1915, article XIII of the bylaws of plaintiff was amended to read as follows:

Participation by Officers and Employees in Certain Profits

All the Company's officers and employees who have owned its Common Stock and been in its employ for not less than twelve months, then next preceding may be allowed, in the discretion and at the option of the Board of Directors, beginning with the year 1912, to participate in proportion to the Common Stock thus owned, in the Company's annual profits which are in excess of the percentage of profits earned during the year 1910, to wit: 22.19%, not exceeding, however, 10% of those profits in excess of 22.19% of its entire outstanding issue of Common Stock, taking into account pro rata any increase or decrease thereof made during the year. The Common Stock owned by an officer or employee, for the purpose of this By-Law, beginning with the year 1916, shall include any stock purchased during the year from an officer or employee or from the personal representative of a deceased officer or employee, provided such stock would have entitled the former owner to participate in proportion thereto had it been held for the entire 12 months' period.

24. Article XIII of the bylaws was renumbered article XII by action of the board of directors in 1929. Thereafter, the bylaw remained in effect and unchanged until it was again amended in 1949. The bylaw in effect during the years 1940 through 1948, under which the payments at issue were made, was the bylaw as amended in 1915 and renumbered in 1929, quoted in full in the finding above.

25. American, Liggett and Lorillard had profit-sharing bylaws in effect during the years 1940-1948. American's original bylaw was still in effect. While Liggett's original bylaw had been amended to reduce the fund from ten percent to five percent of defined profits, the payments were still restricted to the designated officers. In the case of Lorillard, the bylaw in effect was one adopted in 1921 to supersede the two bylaws adopted in 1912. It was entitled

Bonus to Officers and Employees and provided for distribution of 15 percent of the annual "net profits" of the company among officers and employees who had been in the employ and owned common stock of the company for the entire year "as an extra dividend upon and in the proportion among such officers and employees of such shares of Common Stock thus owned by them respectively." Net profits were consolidated profits after deducting interest on bonds, dividends on preferred stock, $1.50 per share on common stock, and seven percent of surplus for the year. The percentage of issued common stock eligible for participation was limited to three and one-third percent in the case of the president, two percent in the case of the vice presidents, one percent in the case of certain other key personnel, and one-half of one percent in the case of any other officer or employee.

26. The plaintiff issued and sold some preferred stock for the first time in 1915 and has had preferred stock outstanding from time to time thereafter. Effective beginning in 1915 the plaintiff adopted the practice of deducting from annual profits the dividends accrued on its preferred stock in determining the amount of the participation payable under the bylaw. This practice was never approved by the stockholders or directors of the R. J. Reynolds Tobacco Company in a formal manner. American, Liggett and Lorillard had made specific provisions for such deduction in their profit-sharing bylaws as adopted in 1912 and as thereafter amended. This practice of the plaintiff resulted in a reduction of the amount of participation received each year when preferred stock was outstanding. For the years here involved, preferred stock was outstanding from 1945 through 1948 and preferred dividends in the following amounts accrued and were paid:

1945	$ 765,984
1946	1,764,000
1947	1,764,000
1948	1,994,608

27. On January 1, 1934, plaintiff owned 200,000 shares of its common stock which it had acquired, at a cost of $10,120,000, for sale to its employees but had been unable to sell because of the depression. Plaintiff had established in 1929 retirement and group insurance plans for its employees, providing retirement and disability benefits, group life insurance, total and permanent disability insurance, and accident and health insurance. By resolution of the board of directors adopted January 1, 1934, effective December 31, 1933, plaintiff established an account on its books known as the Retirement and Insurance Investment Fund. The resolution provided that the income from such 200,000 shares of common stock, after providing interest on the balance of plaintiff's investment in such stock, should be used in defraying the expense to plaintiff of carrying the retirement and group insurance plans and that any surplus at the end of each year should be applied as a reserve toward the reduction of plaintiff's investment in such stock. The resolution further provided that in order to build up a reserve to reduce the investment, the 200,000 shares of stock should be added to the number of shares qualified for participation under the bylaw in arriving at the per share distribution to qualified employees, beginning with the distribution under the bylaw for the year 1934. The effect of this arrangement was to reduce by about one-fourth the amount per share distributable to employees and to apply that amount toward defraying the cost of the stock and the expense to the company of the employee benefit plans mentioned. By the end of 1948, as a result of building up such reserve, plaintiff's cost of the 200,000 shares of stock had been reduced to $1.

28. On December 6, 1917, January 9, 1919, December 31, 1943, June 14, 1945, and December 9, 1948, respectively, plaintiff's directors adopted resolutions generally authorizing plaintiff's officers to renew notes or continue loans with servicemen previously in the employ of plaintiff who had given notes for loans for the purchase of participating stock, where it appeared reasonably probable that these

employees would continue in plaintiff's employment after their discharge from the service, and also generally to permit such employees to participate in the participation payments during the periods they were in the service.

29. The amount set aside and distributed by the plaintiff under the bylaw for each of the years 1912 to 1948, inclusive, was the maximum percentage of plaintiff's profits which could be so set aside and distributed under the provision of the bylaw, subject to deductions of preferred dividends as set out herein and subject to deductions on account of the 200,000 shares of common stock in the retirement and insurance investment fund.

30. The total participating payments made by the plaintiff to its own employees under bylaw XII, for the years 1940 to 1948, inclusive, are set forth in the following table. In finding 45 this information is supplemented and is broken down by categories of employment.

Year	Number of participants	Total number shares of stock	Total amount of participation paid	Amount of participation paid per share
1940	2,045	651,655	$1,922,382	2.95
1941	2,025	658,843	1,936,998	2.94
1912	1,987	585,816	1,435,249	2.45
1943	1,922	581,063	1,330,634	2.29
1944	1,908	580,015	1,200,631	2.07
1945	1,837	580,323	1,346,349	2.32
1946	1,733	543,260	1,885,112	3.47
1947	1,727	506,165	2,191,694	4.33
1948	1,769	508,606	2,370,104	4.66

These amounts were exclusive of participation on stocks held in the retirement and insurance investment fund.

31. Glenn Tobacco Company, a wholly owned subsidiary of plaintiff, is a North Carolina corporation organized in 1922. It is engaged exclusively in the purchase of leaf tobacco in foreign countries for plaintiff. For the years 1940-1948, Glenn filed separate income tax returns. During

the years 1940-1948 Glenn's capital stock outstanding was $25,000. By agreements between plaintiff and Glenn, the annual net earnings of Glenn were limited to six percent of the capital stock, or $1,500 a year. During such years, plaintiff furnished Glenn with all funds on open account to cover all the expenses and costs of acquiring foreign leaf tobaccos. The portion of the $1,500 annual profit of Glenn remaining after payment of Glenn income taxes was regularly paid to plaintiff as a dividend. Employees of Glenn Tobacco Company who owned common stock of plaintiff have participated under the bylaw since the organization of Glenn, although the bylaw makes no specific reference to Glenn employees.

32. The total participating payments made by plaintiff under bylaw XII to employees of Glenn Tobacco Company, for the years 1940 to 1948, inclusive, are as follows:

Year	Number of employees	Number shares common stock	Total participation paid
1940	19	8,008	$23,624
1941	19	8,501	24,993
1942	19	9,157	22,435
1943	18	9,352	21,416
1944	19	9,455	19,572
1945	14	8,427	19,551
1946	12	6,582	22,839
1947	12	6,829	29,570
1948	12	6,670	31,082

33. Participating payments under bylaw XII were authorized for the years 1940-1948, inclusive, near the end of each year by separate resolution of plaintiff's board of directors and the payments were made in each case to participating employees in January of the following year. Checks were sent directly to the employees by plaintiff. Regular dividends, however, were disbursed quarterly by plaintiff's dividend disbursing agent, the Chase National Bank in New York City.

34. During the years 1940-1948, inclusive, plaintiff paid dividends on its class A common and class B common stock to all holders regardless of whether they were employees or nonemployees as shown in the table below. In addition, payments under the bylaw were made to employees of plaintiff and Glenn Tobacco Company who had been employees for a year and had owned plaintiff's class A common stock for a year, as shown in findings 30 and 32.

Year	Dividends per share	Total paid	Participation payments
1940	$2.25	$22,500,000	$1,922,382
1941	2.10	21,000,000	1,936,998
1942	1.70	17,000,000	1,435,249
1943	1.50	15,000,000	1,330,634
1944	1.50	15,000,000	1,200,631
1945	1.60	16,000,000	1,346,349
1946	1.75	17,500,000	1,885,112
1947	2.00	20,000,000	2,191,694
1948	2.00	20,000,000	2,370,104

In addition, preferred dividends were paid in the total amount of $10,631;250 for the years 1915-1925 when preferred stock was outstanding, and again during the years 1945-1948, in the total amount of $6,288,592. During each of the years 1912-1948 plaintiff paid dividends on its outstanding common stocks at the same rate per share to all stockholders whether or not they were employees.

35. Under bylaw XII as it was in effect during the years 1940-1948, inclusive, participating payments were made in exact proportion to the common stock owned and were out of plaintiff's annual profits and pursuant to the formula set forth in the bylaw. The amounts so paid were in addition to fixed compensation paid the officers or employees and in addition to regular dividends paid on company stock.

There was no limitation in any of the corporate resolutions as to the amount of participating stock which any officer or employee could acquire and hold, as in the case of Lorillard, cited in finding 25. Regardless of the duties, responsibilities or services of these people they were all

entitled to receive the participating payments if and when voted by the directors, based on the amount of stock held for 12 months, and provided they had been in the service continuously for one year prior thereto as provided in the bylaw.

PLAINTIFF'S STOCK ALLOTMENT POLICY

36. Plaintiff had a company policy with respect to ownership of class A common stock by employees. R. J. Reynolds, plaintiff's founder, and his associates, felt that officers and employees "who had the interest of the company at heart" should have opportunity to acquire such common stock and participate in the profits of the company. This incentive was held out to selected officers and employees who were key people. Plaintiff did not want any individual employee to acquire an excessive amount of stock in relation to his value to the company. Prior to his death in 1918, Mr. Reynolds personally encouraged and assisted employees to purchase stock by making loans to them. In some instances he bought stock for employees and carried their loans until their payments brought the debt down to book value, at which time plaintiff took over the loans. For the most part employees bought common stock on credit. During the period 1912-1933, plaintiff extended substantial credit to employees for the purchase of stock. The loans were restricted in amount to the book value of the stock held as collateral. The year-end outstanding balances of receivables from employees for stock purchases varied from $908,000 in 1912 to a high of about $2,975,000 in 1918, after which they gradually declined.

Some employees bought all of the stock they could and others, who had opportunity to buy, did not do so for personal reasons. Generally, the amount of stock that could or should be acquired by an employee was not discussed with him at the time he was employed.

37. Plaintiff never made any profit on sales of common stock to employees. In the case of an immediate sale, the sales price was plaintiff's cost. In the case of a pool, the

price was cost-plus-interest-less-dividends, determined on an average basis for the lots making up a pool. Stock was generally sold to employees for a price below the current market price.

Plaintiff acquired its common stock for allotment and sale to employees from various sources, including nonemployee stockholders and officers or other employees upon their death or resignation. Since 1912 none of the stock allotted to employees was original issue stock. The stock was acquired either for cash or by purchasing plaintiff's B common stock on the New York Stock Exchange and exchanging it for common stock. Some stock was allocated and sold immediately after its acquisition. Other stock was acquired in relatively small lots over a period of time and was allotted and sold in larger blocks called "pools." Plaintiff also influenced the allotments of large blocks of stock sold by others to employees as noted hereafter.

38. In 19[illegible] plaintiff had on hand 100,000 shares of common stock accumulated over a period of several years for resale to employees. The cost was about $67 per share. In order to average the cost, W. N. Reynolds, James A. Gray, Bowman Gray, Sr., and S. Clay Williams, officers and directors of plaintiff, exchanged 100,000 shares of their common stock for 100,000 shares of B stock which plaintiff had acquired at a cost of $34 per share. Since A stock in the hands of the officers was of greater value per share than B stock, this share-for-share exchange represented a substantial financial sacrifice by these four officers. The resulting average cost to plaintiff of the 200,000 shares of common was $50.60 per share. The continuance of the depression prevented the sale of this stock to employees even at such reduced price. These were the 200,000 shares in the retirement and insurance investment fund heretofore described.

39. Plaintiff's loans to employees for stock purchases were represented by demand notes of the employees. Plaintiff required that payments under the bylaw, regular dividends, and any other rights accruing on stock held as collateral be applied on the notes. In many instances, the

loans were satisfied in full by the application of these amounts. Plaintiff did not make loans to employees to purchase B stock.

40. In 1932, because of the economic depression, stocks lost their value, money was withdrawn from banks, and plaintiff's employees who had loans from banks other than Wachovia Bank and Trust Company, Winston-Salem, North Carolina—mainly banks outside of Winston-Salem—were being called to pay the loans. In order to aid these distressed employees, plaintiff during that year put $200,000 in certificates of deposit with Wachovia to supply Wachovia with funds to take over the employee loans called by such other banks. The loans taken over by Wachovia were taken over pursuant to designation of James A. Gray.

41. Prior to 1920, allocation of class A common stock to employees was handled primarily by R. J. Reynolds and the company treasurer. Beginning January 1, 1920, such stock allocation was handled primarily by James A. Gray who headed a stock allotment committee of three directors. When class A common stock was available for sale to employees the usual procedure was to send letters to department managers, superintendents and other supervisory people requesting the names of employees they could recommend as having "the interest of the company at heart" and the amount of stock each such employee wished to purchase. The data so gathered were assembled and reviewed by the committee which made the final decision regarding the allotment. It was the desire of plaintiff that class A common stock should not be acquired without the approval of management. But, there was no corporate resolution concerning the manner or method under which acquisition could or would be made and no express directions to employees as to the amount of stock which they could acquire. The view of the management that it should approve common stock acquisitions by employees was passed by word of mouth on an informal basis. Plaintiff's management sometimes reprimanded employees who had acquired such stock without approval and warned them not to let it happen

again. However, no employee was ever discharged for acquiring too much stock. Employees sometimes acquired class A stock by gift, exchange, inheritance or purchase from other employees and holders of the stock, without advance notice to the company. Shares were traded on the New York Stock Exchange. Between 1922 and 1948 a total of 89,475 class A common shares were so traded at a rate which varied annually from 630 to 9,070 shares. From 1940 through 1948, 32,418 shares were traded on the New York Exchange. There is no evidence that all of the purchasers were plaintiff's employees. As indicated in finding 37, stock was sometimes acquired by plaintiff's employees from directors and estates of plaintiff's directors. From 1940 through 1948 the total number of shares involved in this type of transaction was 105,248. To the extent that the company had control over the allocation of stock acquired through trusts or estates, it generally took into consideration, in making allocations, ability, present and potential interest, loyalty and sometimes length of service of employees. Existing common stockholdings of an employee were also considered. Mr. Gray and his committee were concerned, also, to assure that participation of existing employee stockholders was not adversely affected by the acquisition and distribution of shares among employees.

On one occasion plaintiff acquired a large block of stock from the Baltimore Safe Deposit and Trust Company, trustee of the estate of one of plaintiff's deceased officials. In the case of this stock, all shareholding employees were given the same rights with respect to acquiring it, namely one share for each three shares held and, ultimately, new employees and other employees not holding stock were offered small holdings. Because of the economic depression of the 1930's about 29,000 shares of stock were defaulted by employees who had bought it on credit. The defaulted stock was reallotted and when not sold was set up in a special account.

After 1935, because of regulations of the Securities and Exchange Commission, plaintiff did not itself acquire and sell stock to its employees. However, stock acquisitions

continued to be reviewed by the above referred to committee at least through 1948.

42. Banks made more loans to employees for the purchase of stock than did plaintiff, and plaintiff encouraged its employees to borrow from their own banks for this purpose. Wachovia Bank made loans in large volume to employees to finance purchases of plaintiff's common stock. The amount of such loans by Wachovia was far in excess of the amount loaned by all other Winston-Salem banks. At one time the outstanding loans made by Wachovia were between $5,000,000 and $6,000,000. Wachovia, like plaintiff, required that the payments under the bylaw be applied on the loans. Stock which was sold to employees out of the estates handled by the Wachovia Bank and Trust Company was sold for the best price which the bank could secure, usually prices as listed on the New York Stock Exchange. Generally, fair market prices were charged for all stock.

43. When an employee of plaintiff went to Wachovia to apply for a loan to purchase common stock the bank obtained information about his salary, dividends and payments under the bylaw. It was important for the bank to know whether the stock was in line for participation from the seller and to determine whether the buyer had the required time with the company and was entitled to participate, as the common stock selling between the two would clear a higher price than the general market for the stock. Wachovia officials maintained a close contact with plaintiff's management on these matters and thus plaintiff was informed of all sales and purchases of its stock when Wachovia was the purchaser or seller or was making loans for purchase to plaintiff's employees. Sometimes the bank would discourage or reject an otherwise qualified borrower when plaintiff indicated the employee was getting out of line on his stock compared to his responsibilities. Wachovia Bank was executor of numerous estates of deceased officials and other employees of plaintiff and disposed of various amounts of common stock owned by these estates. In sell-

ing this stock the bank cooperated closely with plaintiff along the lines indicated above and sometimes sold the stock to employees on a list compiled by plaintiff's management. It is not shown by the evidence whether other banks from which employees obtained loans to buy stock cooperated with plaintiff's management as did Wachovia.

44. The number of individuals participating under the bylaw was 27 for the year 1912, eight of whom were directors of plaintiff. Thereafter, the number of participants increased almost every year through 1928, the greatest increase occurring in the period from 1921 through 1928, during which the number increased from 308 in 1921 to 2,177 in 1928, which marked the largest number of individuals ever to participate under the bylaw. The number of participants dropped off in the early 1930's and gradually increased back to slightly more than 2,000 by 1937 and remained practically static through 1941. The amount of participating common stock owned by employees followed to a large degree the same pattern as the number of participants. The number of shares participating for 1912 was 191,400. By 1920, the number had increased to 250,490, by 1928 to 850,037, the largest number of shares ever to participate. Thereafter, the number of shares gradually declined. The percentage of total participation payments going to the directors almost constantly declined from 1912 through 1948, and for the years in question it declined from 36.60 percent in 1940 to 21.92 percent in 1948. The number of employees of Glenn Tobacco Company participating under the bylaw varied from a low of eight for 1923 to a high of 23 for 1929 and 1931. In the period 1922-1948, the number of participating shares owned by Glenn employees varied from a low of 1,912 in 1924 to a high of 11,017 in 1939.

45. The following is a summary for each of the years 1940–1948 showing the categories of employment of the participating employees, the number of individuals, the number of participating shares, the dollar amount of participation paid, the fixed compensation, and the total fixed compensation and participation:

YEAR 1940

	Number persons	Number shares common stock	Participation paid	Fixed salary	Total salary and participation
Officers and directors	14	245,580	$724,461.00	$343,050.00	$1,067,511.00
Junior executive and professional	16	43,915	129,549.25	105,910.00	235,459.25
General office administrative and clerical	175	40,810	120,389.50	369,821.00	490,210.50
Sales department	744	148,464	437,968.80	1,727,849.00	2,165,817.80
Total executive, administrative and selling	949	478,769	1,412,368.55	2,546,630.00	3,958,998.55
Manufacturing, engineering and service	777	76,459	225,554.05	1,328,314.00	1,553,868.05
Leaf processing	159	18,569	54,778.55	312,636.00	367,414.55
Leaf department	141	69,850	206,057.50	444,621.00	650,678.50
Glenn Tobacco Co	19	8,008	23,623.60	106,580.00	130,203.60
Total manufacturing, leaf and Glenn Tobacco Co	1,096	172,886	510,013.70	2,192,151.00	2,702,164.70
Grand total	2,045	651,655	1,922,382.25	4,738,781.00	6,661,163.25

YEAR 1941

	Number persons	Number shares common stock	Participation paid	Fixed salary	Total salary and participation
Officers and directors	14	241,080	$708,775.20	$354,201.00	$1,062,976.20
Junior executive and professional	17	46,140	135,651.60	112,798.00	248,449.60
General office administrative and clerical	167	43,892	129,042.48	367,721.00	496,763.48
Sales department	762	151,620	445,762.80	1,782,013.00	2,227,775.80
Total executive, administrative and selling	960	482,732	1,419,232.08	2,616,733.00	4,035,965.08
Manufacturing, engineering and service	751	74,133	217,951.02	1,395,172.00	1,613,123.02
Leaf processing	152	22,664	66,632.16	315,621.00	382,253.16
Leaf department	143	70,813	208,190.22	445,116.00	653,306.22
Glenn Tobacco Co	19	8,501	24,992.94	80,632.00	105,624.94
Total manufacturing, leaf and Glenn Tobacco Co	1,065	176,111	517,766.34	2,236,541.00	2,754,307.34
Grand total	2,025	658,843	1,936,998.42	4,853,274.00	6,790,272.42

YEAR 1942

Officers and directors	14	179,088	$438,765.60	$390,968.00	$829,733.60
Junior executive and professional	17	35,310	86,509.50	120,213.00	206,722.50
General office administrative and clerical	167	43,081	105,548.45	388,933.00	494,481.45
Sales department	730	153,067	375,014.15	1,714,294.00	2,089,308.15
Total executive, administrative and selling	928	410,546	1,005,837.70	2,614,408.00	3,620,245.70
Manufacturing, engineering and service	748	74,134	181,628.30	1,530,087.00	1,711,715.30
Leaf processing	153	22,843	55,965.35	331,281.00	387,246.35
Leaf department	139	69,136	169,383.20	434,810.00	604,193.20
Glenn Tobacco Co	19	9,157	22,434.65	41,897.00	64,331.65
Total manufacturing, leaf and Glenn Tobacco Co	1,059	175,270	429,411.50	2,338,075.00	2,767,486.50
Grand total	1,987	585,816	1,435,249.20	4,952,483.00	6,387,732.20

YEAR 1943

Officers and directors[a]	13	172,749	$395,574.60	$889,667.00	$785,241.60
Junior executive and professional	16	35,475	81,237.75	118,600.00	199,837.75
General office administrative and clerical	169	40,775	93,374.75	386,386.00	479,760.75
Sales department	672	153,202	350,832.58	1,508,049.00	1,858,881.58
Total executive, administrative and selling	870	402,192	921,019.68	2,402,702.00	3,323,721.68
Manufacturing, engineering and service	741	76,953	176,222.37	1,513,158.00	1,689,380.37
Leaf processing	157	25,106	57,492.74	345,558.00	403,050.74
Leaf department	137	67,460	154,483.40	414,361.00	568,844.40
Glenn Tobacco Co	18	9,352	21,416.08	41,807.00	63,223.08
Total manufacturing, leaf and Glenn Tobacco Co	1,053	178,871	409,614.59	2,314,884.00	2,724,498.59
Grand total	1,923	581,063	1,330,634.27	4,717,586.00	6,048,220.27

[a] Includes 1 director who died during year and received salary but no participation.

YEAR 1944

	Number persons	Number shares common stock	Participation paid	Fixed salary	Total salary and participation
Officers and directors	12	167,160	$346,021.20	$383,000.00	$729,021.20
Junior executive and professional	16	35,360	73,195.20	123,120.00	196,315.20
General office administrative and clerical	174	41,443	85,787.01	408,743.00	494,530.01
Sales department	648	154,062	318,908.34	1,417,142.00	1,736,050.34
Total executive, administrative and selling	850	398,025	823,911.75	2,332,005.00	3,155,916.75
Manufacturing, engineering and service	739	81,123	167,924.61	1,595,140.00	1,763,064.61
Leaf processing	170	26,130	54,089.10	398,969.00	453,058.10
Leaf department	130	65,282	135,133.74	413,241.00	548,374.74
Glenn Tobacco Co	19	9,455	19,571.85	49,088.00	68,659.85
Total manufacturing, leaf and Glenn Tobacco Co	1,058	181,990	376,719.30	2,456,438.00	2,833,157.30
Grand total	1,908	580,015	1,200,631.05	4,788,443.00	5,989,074.05

YEAR 1945

Officers and directors	16	177,990	$412,936.80	$448,908.00	$861,844.80
Junior executive and professional	15	26,408	61,266.56	96,339.00	157,605.56
General office administrative and clerical	170	42,774	99,235.68	419,140.00	518,375.68
Sales department	587	151,834	352,254.88	1,241,959.00	1,594,213.88
Total executive, administrative and selling	788	399,006	925,693.92	2,206,346.00	3,132,039.92
Manufacturing, engineering and service	753	87,353	202,658.96	1,764,383.00	1,967,041.96
Leaf processing	162	27,510	63,823.20	418,356.00	482,179.20
Leaf department	120	58,027	134,622.64	377,737.00	512,359.64
Glenn Tobacco Co	14	8,427	19,550.64	61,448.00	80,998.64
Total manufacturing, leaf and Glenn Tobacco Co	1,049	181,317	420,655.44	2,621,924.00	3,042,579.44
Grand total	1,837	580,323	1,346,349.36	4,828,270.00	6,174,619.36

YEAR 1946

Officers and directors	17	146,405	$508,025.35	$494,500.00	$1,002,525.35
Junior executive and professional	14	23,303	80,861.41	107,862.00	188,723.41
General office administrative and clerical	165	46,336	160,785.92	504,519.00	665,304.92
Sales department	484	146,662	508,917.14	1,557,147.00	2,066,064.14
Total executive, administrative and selling	680	362,706	1,258,589.82	2,664,028.00	3,922,617.82
Manufacturing, engineering and service	754	87,645	304,128.15	2,191,737.00	2,495,865.15
Leaf processing	167	32,221	111,806.87	510,250.00	622,056.87
Leaf department	120	54,106	187,747.82	468,509.00	656,256.82
Glenn Tobacco Co	12	6,582	22,839.54	67,079.00	89,918.54
Total manufacturing, leaf and Glenn Tobacco Co	1,053	180,554	626,522.38	3,237,575.00	3,864,097.38
Grand total	1,733	543,260	1,885,112.20	5,901,603.00	7,786,715.20

YEAR 1947

	Number persons	Number shares common stock	Participation paid	Fixed salary	Total salary and participation
Officers and directors[b]	18	117,225	$507,584.25	$527,925.00	$1,035,509.25
Junior executive and professional	14	23,742	102,802.86	126,805.00	229,607.86
General office administrative and clerical	172	47,330	204,938.90	603,650.00	808,588.90
Sales department	467	130,052	563,125.16	1,726,387.00	2,289,512.16
Total executive, administrative and selling	671	318,349	1,378,451.17	2,984,767.00	4,363,218.17
Manufacturing, engineering and service	766	94,909	410,955.97	2,516,642.00	2,927,597.97
Leaf processing	166	34,102	147,661.66	587,288.00	734,949.66
Leaf department	114	51,976	225,056.08	500,685.00	725,741.08
Glenn Tobacco Co	12	6,829	29,569.57	82,820.00	112,389.57
Total manufacturing, leaf and Glenn Tobacco Co	1,058	187,816	813,243.28	3,687,435.00	4,500,678.28
Grand total	1,729	506,165	2,191,694.45	6,672,202.00	8,863,896.45

YEAR 1948

Officers and directors[b]	18	111,485	$519,520.10	$547,028.00	$1,066,548.10
Junior executive and professional	13	16,058	74,830.28	126,833.00	201,663.28
General office administrative and clerical	167	49,029	228,475.14	628,422.00	856,897.14
Sales department	470	131,843	614,388.38	1,915,942.00	2,530,330.38
Total executive, administrative and selling	668	308,415	1,437,213.90	3,218,225.00	4,655,438.90
Manufacturing, engineering and service	793	106,695	497,198.70	2,518,312.00	3,015,510.70
Leaf processing	180	34,256	159,632.96	619,799.00	779,431.96
Leaf department	118	52,570	244,976.20	562.186.00	807,162.20
Glenn Tobacco Co	12	6,670	31,082.20	74,463.00	105,545.20
Total manufacturing, leaf and Glenn Tobacco Co	1,103	200,191	932,890.06	3,774,760.00	4,707,650.06
Grand total	1,771	508,606	2,370,103.96	6,992,985.00	9,363,088.96

[b] Includes 2 directors who retired during year and received salary but no participation.

46. For each of the years 1940 to 1948, inclusive, all of the officers and directors of plaintiff were full-time employees and were participants under the bylaw, with the exception of R. J. Reynolds, Jr., who was a director from May 1942 until plaintiff's annual meeting in 1947.

47. The following schedules set out for each of the years 1946, 1947 and 1948[1] data with respect to the number of regular employees (excluding officers and directors, but including Glenn employees) participating under the bylaw, broken down by fixed compensation brackets, on the payroll at the end of the year:

[1] Data for prior years not in existence at the time of the trial of this case.

YEAR 1946

Fixed compensation bracket	Number regular employees	Number participants	Percent regular employees participating
17,000 to 17,999	1	1	100
12,000 to 12,999	3	3	100
11,000 to 11,999	1	1	100
10,000 to 10,999	7	6	85.7
9,000 to 9,999	7	7	100
8,000 to 8,999	11	11	100
7,000 to 7,999	23	22	95.7
6,000 to 6,999	26	24	92.3
5,000 to 5,999	68	60	88.2
4,000 to 4,999	230	189	82.2
3,000 to 3,999	731	416	56.9
2,000 to 2,999	3,162	721	22.8
0 to 1,999	6,448	[a] 255	4.0
Employed within the year, and on roll at year end	1,272	0	
Total	11,990	1,716	14.3

[a] Includes 54 employees in military service during year with no fixed compensation or for part of year only.

YEAR 1947

Fixed compensation bracket	Number regular employees	Number participants	Percent regular employees participating
19,000 to 19,999	1	1	100
18,000 to 18,999	1	1	100
14,000 to 14,999	1	1	100
13,000 to 13,999	1	1	100
12,000 to 12,999	4	4	100
11,000 to 11,999	3	3	100
10,000 to 10,999	4	4	100
9,000 to 9,999	11	11	100
8,000 to 8,999	21	21	100
7,000 to 7,999	21	21	100
6,000 to 6,999	31	29	93.5
5,000 to 5,999	104	91	87.5
4,000 to 4,999	361	270	74.8
3,000 to 3,999	1,305	597	45.7
2,000 to 2,999	3,570	534	15.0
0 to 1,999	5,338	122	2.3
Employed within the year, and on roll at year end	1,937	0	
Total	12,714	1,711	13.5

YEAR 1948

Fixed compensation bracket	Number regular employees	Number participants	Percent regular employees participating
20,000 to 20,999	2	2	100
15,000 to 15,999	1	1	100
14,000 to 14,999	2	2	100
13,000 to 13,999	2	2	100
12,000 to 12,999	2	2	100
11,000 to 11,999	5	5	100
10,000 to 10,999	9	9	100
9,000 to 9,999	15	14	93.3
8,000 to 8,999	24	24	100
7,000 to 7,999	20	19	95
6,000 to 6,999	58	50	86.2
5,000 to 5,999	129	113	87.6
4,000 to 4,999	315	224	71.1
3,000 to 3,999	1,352	649	48
2,000 to 2,999	4,352	533	12.3
0 to 1,999	5,093	104	2.0
Employed within the year, and on roll at year end	1,280	0	———
Total	12,661	1,753	13.9

48. During the years 1940-1948, 80 to 100 percent of plaintiff's leaf tobacco buyers owned common stock. During these years, 78 to 98 percent of the sales division managers and assistants owned participating stock. Thirty-six to 58 percent of the salesmen, exceluding those in the Armed Forces, owned such stock.

Imperfections in Operation of Bylaw

49. Plaintiff's plan for employee participation in profits was unique when started in 1912. It was different from the plans of competitors where only top officials participated. Over the years, however, two imperfections developed in the plan. Some employees did not acquire as much stock as was appropriate and some got too much. Some employees simply could not, for personal reasons, invest money in the stock to the extent that their positions and records would have entitled them in the management's view. On the other

hand, some employees purchased stock or acquired it by gift or inheritance out of all proportion to their value to the company. Their bylaw payments thus were greater than they should have been and their total compensation was excessive in relation to other employees in generally similar categories of employment or even to other employees in higher employment classifications. Sometimes excessive stock ownership came about as a result of the company having encouraged ownership by an individual whose prospects of future value to the company were misjudged and sometimes by purchases without management approval, as heretofore noted. It was the view of plaintiff's management, however, that the defects in the plan as described above did not affect the overall success of the plan through the years and, further, that excessive acquisitions did not cost plaintiff anything since a specified percentage of profits was paid to participants, whoever they might be.

50. The following tabulation shows for each of the years 1940-1948 the amount of the bylaw payments which, when added to fixed compensation, plaintiff admits exceeded a reasonable allowance for personal services rendered by the individual recipients. The tabulation also shows the total payments under the bylaw, the total fixed compensation plus bylaw payments of participating employees, and the percentage of the excessive bylaw payments to the latter.

Year	(1) Amount of excessive by-law payments	(2) Total by-law payments	(3) Total fixed compensation and bylaw payments of participants	Percent (1) to (3)
1940	$113,514.75	$1,922,382.25	$6,661,163.25	1.70
1941	138,934.70	1,936,998.42	6,790,272.42	2.05
1942	96,284.25	1,435,249.20	6,387,732.20	1.51
1943	92,313.85	1,330,634.27	6,048,220.27	1.53
1944	72,029.55	1,200,631.05	5,989,074.05	1.20
1945	94,020.80	1,346,349.36	6,174,619.36	1.52
1946	179,570.00	1,885,112.20	7,786,715.20	2.31
1947	247,280.00	2,191,694.45	8,863,896.45	2.79
1948	286,750.00	2,370,103.96	9,363,088.96	3.06

51. The tabulation below shows for each of the years 1940-1948 the number of employees plaintiff admits received excessive bylaw payments as stated in the finding above, the total number of employees participating under the bylaw, and the percentage of the former to the latter:

Year	(1) Number of employees who received excessive payments	(2) Total number of participants	Percent (1) to (2)
1940	51	2,045	2.49
1941	53	2,025	2.62
1942	46	1,987	2.32
1943	43	1,922	2.24
1944	42	1,908	2.20
1945	44	1,837	2.40
1946	79	1,733	4.56
1947	96	1,727	5.56
1948	98	1,769	5.54

Plaintiff's Business Record

52. In 1912 plaintiff was the smallest of the four principal tobacco companies that emerged from the dissolution of the American Tobacco Trust. In assets and sales it was about one-third as large as Lorillard and less than one-fourth the size of Liggett. Plaintiff had about one-fifth the sales and one-twelfth the assets of American.

53. The increases in capital and surplus of the four companies by 1948, compared with 1912, were as follows:

Year	Capital and surplus (end of year)		Percent increase
	1912	1948	
	(000)	*(000)*	
Reynolds	$ 15,844	$269,187	1,599.0
American	133,250	323,435	142.7
Liggett	42,683	188,877	342.5
Lorillard	28,198	56,774	101.3

54. During the years 1940-1948, plaintiff paid out a greater percentage of its equity capital in the form of dividends (on common and preferred stocks) than did American, Liggett or Lorillard, except in the case of Liggett for 1948.

55. The increases in net sales of the four companies by 1948, compared with 1912, were as follows:

Year	1912 net sales	1948 net sales	Percent increase
	(000)	*(000)*	
Reynolds	$20,976	$715,812	3,312.5
American	*104,880	873,467	732.8
Liggett	*83,904	556,507	563.3
Lorillard	*62,928	140,279	122.9

* Approximated.

56. The following tabulation shows the net sales of the four companies for each of the years 1940-1948:

Year	Reynolds	American	Liggett	Lorillard
	(000)	*(000)*	*(000)*	*(000)*
1940	$292,039	$285,753	$246,266	$78,909
1941	323,020	363,549	275,104	83,833
1942	369,212	442,152	294,352	100,526
1943	414,263	529,422	347,258	117,332
1944	387,997	533,374	374,033	123,790
1945	430,966	557,558	399,213	126,429
1946	613,106	764,168	464,508	124,047
1947	708,494	819,631	513,771	127,920
1948	715,812	873,467	556,507	140,279
Total	4,254,909	5,169,074	3,471,012	1,023,065

57. The equity capital figures of the four companies for the years 1940-1948[2] were as follows:

Year	Reynolds	American	Liggett	Lorillard
	(000)	*(000)*	*(000)*	*(000)*
1940	$145,233	$216,918	$151,131	$43,461
1941	148,281	218,126	154,324	44,428
1942	152,471	212,381	155,029	45,096
1943	155,331	219,990	156,011	46,064
1944	158,894	224,668	159,727	51,465
1945	161,712	224,451	162,580	52,138
1946	212,413	226,323	165,078	52,740
1947	221,121	240,028	169,438	53,725
1948	231,489	302,854	176,762	55,185
Total	1,586,945	2,085,739	1,450,080	444,302

58. The following tabulation shows the earnings before taxes on income of the four companies for the years 1940-1948:

Year	Reynolds	American	Liggett	Lorillard
	(000)	*(000)*	*(000)*	*(000)*
1940	$36,442	$39,047	$27,820	$5,139
1941	44,700	45,034	30,907	4,918
1942	44,663	55,038	33,247	7,410
1943	36,316	56,145	36,206	8,395
1944	31,619	41,889	32,992	9,882
1945	34,535	37,642	26,643	7,645
1946	49,309	49,423	31,266	5,662
1947	56,703	56,290	38,561	8,946
1948	60,939	72,264	49,423	9,144
Total	395,226	452,772	307,065	67,142

[2] Beginning of year.

59. The following tabulation shows the percentages of earnings before taxes to net sales of the four companies for the years 1940-1948:

Year	Reynolds	American	Liggett	Lorillard
1940	12.5	13.7	11.3	6.5
1941	13.8	12.4	11.2	5.9
1942	12.1	12.4	11.3	7.4
1943	8.8	10.6	10.4	7.2
1944	8.1	7.9	8.8	8.0
1945	8.0	6.8	6.7	6.0
1946	8.0	6.5	6.7	4.6
1947	8.0	6.9	7.5	7.0
1948	8.5	8.3	8.9	6.5
1940-48*	9.29	8.76	8.85	6.56

* Percent of total earnings for period to total sales for period.

60. The following tabulation shows the percentages of earnings before taxes to equity capital (capital stock and surplus) of the four companies for the years 1940-1948:

Year	Reynolds	American	Liggett	Lorillard
1940	25.1	18.0	18.4	11.8
1941	30.1	20.6	20.0	11.1
1942	29.3	25.9	21.4	16.4
1943	23.4	25.5	23.2	18.2
1944	19.9	18.6	20.7	19.2
1945	21.4	16.8	16.4	14.7
1946	23.2	21.8	18.9	10.7
1947	25.6	23.5	22.8	16.7
1948	26.3	23.9	28.0	16.6
1940-48*	24.90	21.71	21.18	15.11

* Percent of total earnings for period to total equity capital for period.

61. In World War II leaf tobacco was under allocation. Annual quotas were fixed or allotted on the basis of previous usage of tobacco from inventory. Plaintiff decided not to sacrifice quality for quantity by removing from inventory leaf which was not properly aged and matured. This policy depressed the quotas allotted to plaintiff and adversely affected its volume of sales and earnings.

62. During the many years following the adoption of bylaw XII, the operation of the plan thereunder materially aided the progress and development of plaintiff. On June 29, 1949, however, an amendment was adopted which gradually decreases the percentage of profits available for distribution so that it will be a nullity by 1959. The management decided to abandon the plan due to the very high rates of income tax and on account of restrictions on borrowing for the purchase of listed stocks which made it difficult for newer employees, lacking outside resources, to acquire stock in sufficient quantities for the bylaw to serve as an incentive to them.

63. The ownership of A common stock by plaintiff's employees had a more stimulating and beneficial effect on them than ownership of B stock. This effect came about as a result of the fact that class A common carried both a regular dividend and bylaw participation payments while B stock paid only the regular dividend. Nothing in the foregoing findings, however, should be construed to mean that the only loyal and efficient employees of plaintiff were holders of class A common stock. It is a fact that, as a general rule, the plaintiff's employees were a loyal working force whether they owned stock or not. Such ownership, however, was an incentive to efficiency and cost consciousness. Plaintiff's purchasing force was very efficient in that it sometimes purchased various grades of tobacco at prices lower than competing companies. Evidence indicates the efficiency of plaintiff's manufacturing processes as well.[3] Plaintiff's sales force and its management as a whole were considered equally efficient.

64. During the years 1946-1948 (data for earlier years being unavailable) employment turnover was substantially

[3] Studies made by the Brown & Williamson Tobacco Corporation, a competitor of plaintiff, revealed to its satisfaction that plaintiff's cost of manufacturing cigarettes was three to five cents lower per thousand than that of its competitors. These studies were not based on exact figures of the other companies due to the impossibility of obtaining such figures; however, the results were considered sufficiently reliable by the Brown & Williamson Tobacco Corporation "to impress upon our own manufacturing people."

lower among employees participating under the bylaw than among nonparticipants. The comparative rates of turnover as between participating employees and nonparticipating employees, based on separations due to dismissals and resignations, were as follows:

Year	Rate of turnover	
	Participants	Nonparticipants
	Percent	*Percent*
1946	6.42	20.57
1947	3.95	9.28
1948	1.57	10.75

FURTHER INDICIA OF NATURE OF BYLAW PAYMENTS.

65. As noted in finding 36, the payments under the bylaw were not generally discussed with new or prospective employees. No representations were made to them as to whether they could buy common stock. Knowledge of the bylaw, however, was soon acquired by employees and even by prospective employees. When known, it was an encouragement to these people to try to become associated with plaintiff and when employees acquired common stock it was an inducement for them to stay with plaintiff. Employees sometimes referred to such payments as a "bonus."

66. Fixed salaries and hourly wages paid to plaintiff's employees on the levels below directors, officers and junor officers, such key employees as plant, department and division managers, and superintendents were at the going rate in the community. Salaried employees did not have fixed salaries larger than comparable positions in the next four or five largest companies in Winston-Salem. In some cases they were lower for the years 1940-1948. This was the view of the employees themselves. Plaintiff made no direct comparison of salaries below officers and directors to those paid by other corporations for comparable jobs. It is a

fact, however, that plaintiff paid its buyers lower fixed salaries than some competitors. In 1946 the fixed salaries of plaintiff's salesmen were low and their starting salaries were lower than competitors'. Salesmen were encouraged to buy common stock to help increase their earnings. While plaintiff sometimes found the situation "tight" it was able to secure the necessary help. Some employees were so much in debt they could not have left the company. In addition to bylaw payments plaintiff had a policy of granting periodic pay raises to its employees as well as raises for meritorious service. When plaintiff gave across-the-board increases to hourly workers it likewise gave raises to supervisory personnel. Plaintiff also maintained for the benefit of its employees a retirement plan, a group life, health and accident insurance plan, and hospitalization and vacation plans.

67. Annually the plaintiff's comptroller made a preliminary determination of the annual profits which he submitted to the board which in turn fixed a specified dollar amount per share to stockholders after the treasurer read aloud to the board a complete list of all participants for the year. The resolution of the board for the years 1940-1945 referred to the participation payments under the bylaw as a "participating dividend" and found that "if such distribution were to be tested upon the basis of reasonable and proper compensation for those receiving same, it, with salary added, would not amount to more than a reasonable and proper compensation to each of said officers and employees for the year."

For the years 1946-1948, the resolution was substantially the same except that the finding with respect to reasonableness was that the distribution "will be reasonable and proper under said By-Law and will serve the purposes and intention thereof."

68. During the two World Wars and following World War II, the board of directors, as noted in finding 28, expressly provided for the continuation of participation payments under the bylaw to employee stockholders in the

military services. This provision was part of a general plan to continue employee benefits, such as family hospitalization and group life insurance.

69. During the period 1940-1948 plaintiff in three instances made long-term borrowings, totaling $150,000,000, in the form of two promissory notes and one issue of debentures. In each of the instruments evidencing the borrowings there was a covenant restricting the payment of dividends by plaintiff on its common stocks under stated conditions. None of plaintiff's short-term notes contained such a restriction. The restrictive covenant in the long-term notes and indenture provided:

> Payments to employees (including officers) of the Company or any Subsidiary pursuant to any profit-sharing plan, including the Plan provided for in Article XII of the By-Laws of the Company, although such payments are made on the basis of or proportionate to shares of stock of the Company owned by such employees, shall not be deemed dividends for the purposes hereof.

70. Plaintiff first claimed in this suit that the following amounts of participation payments made under article XII of its bylaws, are deductible in computing its taxable income, for the years 1940 to 1948, inclusive, and in determining income and excess-profits tax liability for those years. The amounts below are now modified by plaintiff's admission of excessive payments to the extent shown in finding 50.

Year	Amount
1940	$1,922,382.25
1941	1,936,998.42
1942	1,435,249.20
1943	1,330,634.27
1944	1,200,631.05
1945	1,305,726.75
1946	1,925,734.81
1947	2,191,694.45
1948	2,370,103.96

For convenience, the bylaw payments which plaintiff now says are reasonable, considering the admission, are as follows:

Year	Payments to plaintiff's employees	Payments to Glenn employees
1940	$1,785,243.90	$23,623.60
1941	1,773,070.78	24,992.94
1942	1,316,530.30	22,434.65
1943	1,216,904.34	21,416.08
1944	1,109,029.65	19,571.85
1945	1,232,777.92	19,550.64
1946	1,682,702.66	22,839.54
1947	1,914,844.88	29,569.57
1948	2,052,271.76	31,082.20

71. By letter dated August 18, 1949, plaintiff applied to the Commissioner of Internal Revenue for a ruling as to whether payments under the bylaw as amended June 29, 1949, constituted a deductible expense. It was stated that, principally, the amended bylaw was different from the former bylaw in three respects, as follows:

(1) Whereas under the former by-law, the maximum percentage of profits above the base amount which could be paid was 10%, under the amended by-law, the percentage is reduced to 9% for 1950, 8% for 1951, and so on down to 1% for 1958, and none thereafter;

(2) Whereas under the former by-law, a qualified employee could participate with respect to any common stock owned by him for at least a year, under the amended by-law common stock eligible for participation is limited to common stock owned throughout 1949 by officers and employees of plaintiff or its wholly-owned subsidiary and such other common stock as was owned by such officers and employees on May 24, 1949; and

(3) Whereas under the former by-law, the per-share participation was increased by a reduction in the number of participating shares, under the amended

by-law such an increase is precluded in the case of a decrease in the number of shares which participated for 1949.

72. By letter dated December 28, 1949, the Deputy Commissioner of Internal Revenue ruled that the payments pursuant to the amended bylaw would constitute "compensation for personal services rendered" and would therefore be deductible to the extent reasonable. On March 13, 1950, plaintiff filed the claims for refund, covering the years 1940-1948, which constitute the basis of this suit.

73. By letter dated November 13, 1951, the Deputy Commissioner of Internal Revenue revoked his 1949 ruling on the express ground that the changes in the bylaw effected by the 1949 amendment "were not material to the question presented."

74. On December 20, 1951, the Internal Revenue Service forwarded to plaintiff the report of the revenue agent on the claims for refund. In the Findings and Recommendations on page 11 of his report, the agent recommended disallowance of the claims for refund on the express ground that there was no material difference between the original bylaw and the bylaw as amended in 1949, that plaintiff had conceded this, and, therefore, the deductibility issue was governed by the 1951 letter revoking the 1949 ruling.

75. During the years 1940 to 1948, inclusive, plaintiff accrued on its books monthly an estimated portion of the expected year-end distribution under the bylaw by crediting such estimate to an account Provision for Participation by Officers and Employees in Certain Profits, and debiting an account Participation by Officers and Employees in Certain Profits. As of the end of each year, the total of the estimated monthly amounts was adjusted to the actual amount of the payment to be made under the bylaw and charged against income (Income Account) for the year. Following the close of each year, when disbursements were made of

the payments under the bylaw, these amounts were charged against Provision for Participation by Officers and Employees in Certain Profits.

76. For the years 1936, 1937, 1938, and 1939, plaintiff, in computing its undistributed profits surtaxes, treated the participating payments as dividends. Plaintiff was allowed dividends paid credits of two and one-half percent of the participating payments on the claim that they were dividends and thus realized substantial tax benefits in those years through such treatment. This treatment of the payments was in line with the determination of a revenue agent. Plaintiff also did not deduct the participating payments as compensation or otherwise in its State income tax returns.

77. Plaintiff deducted the bylaw participation payments in arriving at book income or net income as reported to stockholders and to the Securities and Exchange Commission in its form 10-K reports. The tax return required a reconcilement of book income with taxable income, and since the Government's position was that the participation payments were not deductible for tax purposes, it was necessary to show these payments as some form of nondeductible item on the tax return in making this reconciliation. Sometimes they were shown as participating dividends, as distribution to stockholders and as an addition to surplus reserves. By and large they were shown as unallowable deductions or nondeductible items on the tax returns. Payments were deducted as one figure in arriving at net earnings and were not distributed or allocated to cost of goods sold or to any other item of cost.

78. Independent auditors, Ernst and Ernst, approved plaintiff's bookkeeping treatment of the bylaw payments and the treatment in the annual reports to stockholders, certifying that such treatment was "in conformity with generally accepted accounting principles." With respect to plaintiff's different treatment of the bylaw payments for tax purposes, the auditors, during the 1930's, raised the

question a number of times with plaintiff's management as to why the payments were not deducted and were told that it was because of a ruling of the Internal Revenue Bureau to the effect that the payments were not deductible.

79. In each of the forms 10-K filed with the Securities and Exchange Commission, pursuant to law, for the years 1946 to 1948, inclusive, plaintiff gave the following answer to the following question:

> Q. State the name of and the amount received by each person who received as bonuses or shares in profits $30,000, or more, from the registrant or its wholly-owned subsidiaries, during the fiscal year.
>
> A. Outside of salaries and wages paid and actual expenses reimbursed, no payment is made to any director, officer or employee of the company except dividends and disbursements in connection with his stockholdings in the company declared by the Board of Directors as ordinary dividends or under Article XII of the Company's By-Laws.

In forms 10-K for 1944 and 1945, the question was the same and the answer similar, the only substantial difference being that the words "disbursement or credit" were used in place of "payment" in the answer.

80. Plaintiff's retirement plans, adopted in 1929 and 1946, defined the terms "wage" and "compensation" so as to exclude bylaw payments for purposes of computing pensions. The 1929 plan excluded the payments in the following terms:

> • • • (not including any amounts received as participation in profits of the Company on account of stock ownership therein) • • •.

The 1946 plan provided as follows:

> "Compensation" means the total earnings, as determined by the Retirement Board, paid for service, as defined herein, excluding (a) any amounts received as participation in profits of the Company, whether on

account of ownership of stock or otherwise, and (b) any amounts paid for insurance or other benefits, including benefits under the Plan.

81. By letter dated December 18, 1942, S. Clay Williams, at that time chairman of plaintiff's board, applied to the Commissioner of Internal Revenue for a ruling as to whether the bylaw payments could be made without violating the salary stabilization laws and regulations, for, if the payments under the bylaw were to be regarded as an additional salary or bonus instead of as a dividend, certain officers of the company would receive amounts in excess of the amounts allowable under the act. The application stated in part as follows:

> Historically, the Bureau has held throughout the period of federal income taxes that the disbursements made under this particular by-law are dividends. This ruling has been consistently applied in the matter of income taxes, excess profits taxes, war profits taxes and undistributed profits taxes affecting the corporation, with the result, of course, that it has not been permitted to deduct such disbur ements as expense items in arriving at taxable income and has been instructed to treat same as dividends in connection with the calculation of undistributed profits taxes.

82. On December 31, 1942, the Commissioner of Internal Revenue replied to the plaintiff, stating in part as follows:

> The special dividends paid or to be paid on the common stock of your company, to your employees who own stock in your company, as described in your letter, and as provided in your bylaws, are preferential dividends, and not bonuses or additional compensation within the meaning of the General Regulations and the Salary Stabilization Regulations, copies of which are enclosed.

83. In each of the years 1940 to 1948, inclusive, the amounts of the participation payments were not treated as compensation by the plaintiff in computing its social security and withholding taxes, both Federal and State.

84. The participation payments to employees of Glenn Tobacco Company were not charged to Glenn nor were they recorded as part of the cost to plaintiff of imported tobaccos which Glenn purchased for and sold to plaintiff.

85. In accordance with Federal and State taxing policies, some of plaintiff's key officers and directors treated the participation payments as dividends in filing their State and Federal income tax returns and did not treat them as compensation or bonuses. They thus secured tax benefits in so reporting their income to the State of North Carolina, inasmuch as dividends were not taxable in North Carolina in full or to the same extent as compensation.

86. In 1940 certain class B common stockholders brought a complaint in the Chancery Court of New Jersey against R. J. Reynolds Tobacco Company, et al., the same being amended in 1943, and alleging that the company and its officers had willfully or negligently wasted corporate assets by failing to deduct the bylaw payments, as an expense of the operation of the corporation business, for income tax purposes. It was alleged that, as a result of the foregoing, certain directors had profited personally in treating the payments as dividends and that the corporation sustained a loss resulting from excessive State and Federal income taxes.

87. In answer to the allegations specified in the preceding finding, Reynolds said that the participation payments were not deductible as expenses in determining income under State and Federal laws. It was admitted that those who had received payments under the bylaw had treated them for income tax purposes as dividends. It was further alleged, among other things, that the distributions in question were lawful incentives for services and were not in misuse or waste of the corporate property.

88. In its decision reported in the case of *Arthur Bookman, et al.*, v. *R. J. Reynolds Tobacco Company, et al.*, 138 N. J. Eq. 312, 48 A. 2d 646, the Chancery Court of New Jersey held for the defendant on the issues raised in the case.

REASONABLENESS OF BYLAW PAYMENTS

89. American, Liggett, Lorillard and plaintiff were all engaged in the tobacco business. They bought leaf tobacco on the same auction markets in competition with each other. They aged and cured the leaf tobacco. They processed or manufactured the tobacco into the finished products, using similar machinery. They were predominantly cigarette manufacturing companies. They used generally similar sales methods, covering the same sales markets and selling to the same dealers. All were in "fierce" competition with each other.

90. The following tabulations show for each of the four companies the total payments (fixed salaries and profit-sharing payments) of the individual officers and directors of plaintiff, American, Liggett and Lorillard, and in the case of plaintiff the fixed salaries of each of the officers and directors, and the totals paid by each company to its officer-director group:

1940

	Reynolds		American	Liggett	Lorillard
	Fixed salary	Total payments			
1	$50,000	$227,000	$456,415	$89,583	$38,038
2	7,800	187,726	251,849	79,583	24,215
3	100,000	150,150	251,849	79,583	25,000
4	20,000	118,825		79,583	
5	35,000	64,500		79,583	
6	15,000	48,925		79,583	
7	15,000	44,907			
8	18,000	44,550			
9	18,000	43,813			
10	15,000	37,125			
11	15,000	32,995			
12	18,000	29,800			
13	8,000	24,225			
14	8,250	12,970			
Others not listed			943,230	171,865	210,456
Total	343,050	1,067,511	1,903,343	659,363	297,709

1941

	Reynolds		American	Liggett	Lorillard
	Fixed salary	Total payments			
1	$50,000	$226,400	$288,145	$78,472	$40,000
2	7,800	182,706	150,887	68,472	25,000
3	100,000	144,100	150,887	68,472	25,000
4	20,000	118,490		68,472	
5	35,000	61,460		68,472	
6	15,000	48,810		68,472	
7	20,417	46,876			
8	20,417	46,142			
9	15,000	44,806			
10	15,000	37,050			
11	16,350	34,284			
12	20,417	32,177			
13	9,400	25,570			
14	9,400	14,104			
Others not listed			794,049	150,001	192,569
Total	354,201	1,062,975	1,383,968	570,833	282,569

1942

1	$50,000	$197,000	$240,473	$71,070	$29,091
2	100,000	129,400	122,284	61,070	25,000
3	20,000	102,075	122,284	61,070	25,000
4	35,000	57,050	116,667	61,070	23,858
5	29,167	51,216	54,000	61,070	20,000
6	29,167	50,604	50,000	61,070	19,649
7	17,500	45,675	44,166	40,000	17,837
8	17,500	42,338	44,166	32,000	17,646
9	29,167	38,967	40,000	27,000	17,646
10	17,500	35,875	40,000	22,500	17,263
11	19,667	34,612	33,000	19,000	15,739
12	11,700	25,175	30,000	9,000	11,750
13	11,700	16,845	26,667		11,046
14	2,900	2,900	26,000		200
15			23,667		
16			20,000		
17			14,023		
Others not listed					30,956
Total	390,968	829,732	1,047,397	525,920	282,681

1943

	Reynolds		American	Liggett	Lorillard
	Fixed salary	Total payments			
1	$50,000	$187,400	$257,276	$72,415	$33,694
2	100,000	138,930	132,365	62,415	28,078
3	20,000	96,715	132,365	62,415	28,078
4	35,000	55,610	120,000	62,415	22,463
5	30,000	50,724	54,000	62,414	22,463
6	30,000	50,037	50,000	61,414	20,217
7	18,000	44,335	45,000	40,600	20,000
8	30,000	36,275	45,000	27,500	19,649
9	21,667	35,636	40,000	23,000	19,649
10	18,000	35,175	40,000	21,500	17,646
11	12,000	24,595	33,000	19,500	13,478
12	13,000	17,809	30,000	9,200	12,233
13	12,000	12,000	27,000		6,000
14			26,000		
15			24,834		
16			20,000		
Others not listed					*71,199
Total	389,667	785,241	1,076,840	524,788	334,847

See footnote at end of table.

1944

1	$50,000	$174,200	$186,153	$68,288	$36,833
2	100,000	135,190	120,000	58,288	29,583
3	20,000	89,345	89,692	58,288	29,583
4	35,000	50,235	89,692	58,288	24,334
5	30,000	48,733	54,000	57,288	24,334
6	30,000	43,559	50,000	53,431	22,425
7	18,000	41,805	45,000	24,166	20,525
8	25,000	37,627	45,000	23,000	20,525
9	18,000	33,525	40,000	22,917	20,000
10	30,000	32,070	40,000	22,500	18,300
11	12,000	23,385	33,000	22,000	14,700
12	15,000	19,347	30,000	21,500	13,250
13			30,000	20,000	1,000
14			27,000	13,933	
15			25,000	13,533	
16			20,000	9,200	
17			2,615		
Others not listed					*73,708
Total	383,000	729,021	927,152	546,620	349,100

1945

	Reynolds		American	Liggett	Lorillard
	Fixed salary	Total payments			
1	$50,000	$189,200	$168,309	$87,563	$43,500
2	100,000	139,440	120,000	57,563	33,750
3	20,000	97,720	78,986	56,563	31,500
4	35,000	52,075	78,986	47,822	27,750
5	30,000	50,996	54,844	47,522	27,750
6	30,000	44,964	54,000	35,768	27,400
7	18,000	44,680	46,511	27,750	22,425
8	26,042	40,194	45,000	27,000	21,200
9	18,000	35,400	45,000	26,610	20,000
10	30,000	30,464	40,000	25,000	18,900
11	11,650	26,742	33,000	22,166	17,000
12	21,966	26,606	30,833	21,666	14,833
13	13,250	26,010	30,000	20,000	1,000
14	15,000	19,872	27,000		
15	15,000	18,944	25,000		
16	15,000	18,538	21,333		
17			6,628		
Others not listed					*65,829
Total	448,908	861,845	905,430	482,993	372,837

1946

1	$100,000	$158,990	$295,612	$86,080	$60,000
2	50,000	152,365	285,669	76,080	45,000
3	20,000	136,245	230,501	75,579	36,000
4	46,250	71,789	230,501	73,080	36,000
5	34,500	65,903	230,501	73,080	36,000
6	19,500	59,405	230,501	71,079	31,962
7	32,250	54,632	120,000	36,000	20,400
8	29,375	50,542	56,248	35,000	20,000
9	19,500	45,525	45,000	35,000	16,500
10	12,000	34,902	45,000	34,000	15,000
11	33,750	34,444	40,000	31,500	14,000
12	15,000	34,085	35,000	24,000	13,333
13	20,000	25,899	35,000		13,000
14	18,000	23,292	35,000		11,350
15	15,000	22,287	30,333		1,000
16	20,000	20,069	30,000		58
17	9,375	12,151	29,935		
18			25,000		
19			17,417		
20			15,438		
Others not listed			11,167		*71,124
Total	494,500	1,002,525	2,073,823	650,478	440,727

See footnote at end of table.

1947

	Reynolds		American	Liggett	Lorillard
	Fixed salary	Total payments			
1	$100,000	$162,785	$484,202	$108,379	$60,000
2	50,000	158,250	268,522	98,379	45,000
3	15,142	101,742	268,522	98,379	36,000
4	65,000	96,869	268,522	95,379	36,000
5	40,000	79,186	268,522	95,379	36,000
6	20,000	63,300	268,522	93,379	36,000
7	35,000	62,928	120,000	45,000	23,000
8	30,000	56,413	50,000	45,000	20,400
9	12,000	40,578	50,000	45,000	
10	39,000	39,866	49,583	40,000	
11	15,000	38,815	45,000	28,000	
12	23,667	31,028	44,583	23,500	
13	19,833	26,437	39,583	17,500	
14	15,000	24,093	39,583	12,500	
15	23,667	23,840	34,583		
16	11,283	16,046	29,583		
17	8,333	8,333	22,000		
18	5,000	5,000			
Others not listed			15,000		*156,188
Total	527,925	1,035,509	2,366,310	845,774	448,583

1948

1	$100,000	$179,220	$447,805	$133,730	$85,144
2	62,500	179,000	246,712	123,730	65,115
3	19,500	112,700	246,712	123,730	51,086
4	50,000	92,173	246,712	120,731	51,086
5	41,500	71,557	246,712	120,731	51,086
6	32,500	60,926	120,074	118,730	33,460
7	15,200	49,218	87,865	55,000	29,860
8	43,500	44,432	50,074	55,000	28,960
9	13,500	44,256	50,074	55,000	28,460
10	17,500	43,130	50,074	29,917	27,461
11	27,000	34,922	50,074	29,000	
12	32,500	32,500	40,074		
13	24,000	31,107	40,074		
14	17,000	26,786	35,074		
15	26,000	26,559	35,074		
16	9,900	17,542	30,074		
17	11,900	17,492	29,484		
18	3,028	3,028	27,074		
Others not listed			30,903	22,500	*122,300
Total	547,028	1,066,548	2,110,719	987,799	574,018

* Includes vice president of Federal Tin Co.:

1943	$21,250	1946	24,375
1944	22,125	1947	29,875
1945	21,875	1948	35,500

91. The following tabulation shows for each of the years 1940-1948 a comparison of the total payments to plaintiff's officer-director group with the average of the total payments made by American and Liggett to their respective officer-director groups:

Year	Reynolds	American-Liggett average
1940	$1,067,511	$1,281,353
1941	1,062,975	977,400
1942	829,732	786,659
1943	785,241	800,814
1944	729,021	736,886
1945	861,845	694,212
1946	1,002,525	1,362,151
1947	1,035,509	1,606,042
1948	1,066,548	1,549,259

92. The following tabulation shows for the years 1940-1948 the percentage of total compensation (including bylaw payments) of the officer-director group to net sales for each of the four companies:

Year	Reynolds	American	Liggett	Lorillard
1940	0.37	0.67	0.27	0.38
1941	.33	.38	.21	.34
1942	.22	.24	.18	.28
1943	.19	.20	.15	.29
1944	.19	.17	.15	.28
1945	.20	.16	.12	.29
1946	.16	.27	.14	.36
1947	.15	.29	.16	.35
1948	.15	.24	.18	.41
1940-48*	.20	.27	.17	.33

* Total amounts paid to officer-director groups for entire period as percentages of sales for entire period.

93. The following tabulation shows for the years 1940-1948 the percentage of total compensation (including bylaw payments) of the officer-director group to earnings before taxes for each of the four companies:

Year	Reynolds	American	Liggett	Lorillard
1940	2.93	4.87	2.37	5.79
1941	2.38	3.07	1.85	5.74
1942	1.86	1.90	1.58	3.81
1943	2.16	1.92	1.45	3.99
1944	2.31	2.21	1.66	3.53
1945	2.50	2.41	1.81	4.88
1946	2.03	4.20	2.08	7.78
1947	1.83	4.20	2.19	5.01
1948	1.75	2.92	2.00	6.28
1940-48*	2.14	3.05	1.89	5.04

* Total amounts paid to officer-director groups for entire period as percentages of earnings for entire period.

94. Participating payments to plaintiff's executive officers during the years 1940 to 1948, inclusive, for convenience restated from the table in finding 45, are as follows:

Year	Number of persons	Participation shares	Participation paid	Fixed salary	Total
1940	14	245,580	$724,461.00	$343,050	$1,067,511.00
1941	14	241,080	708,775.20	354,201	1,062,976.20
1942	14	179,088	438,765.60	390,968	829,733.60
1943	13	172,740	395,574.60	389,667	785,241.60
1944	12	167,160	346,021.20	383,000	729,021.20
1945	16	177,990	412,936.80	448,908	861,844.80
1946	17	146,405	508,025.35	494,500	1,002,525.35
1947	18	117,225	507,584.25	527,925	1,035,509.25
1948	18	111,485	519,520.10	547,028	1,066,548.10

95. The chief executive and most important officer of plaintiff was the chairman of its board who "was the man in the driver's seat" and in charge of all operations. For all of the years 1940 through 1948 S. Clay Williams was chairman of the board. Pertinent data about his compensation for the years involved follow:

Year	Fixed Salary	Bylaw payments	Shares owned	Total compensation
1940	$100,000	$50,150	17,000	$150,150
1941	100,000	44,100	15,000	144,100
1942	100,000	29,400	12,000	129,400
1943	100,000	38,930	17,000	138,930
1944	100,000	35,190	17,000	135,190
1945	100,000	39,440	17,000	139,440
1946	100,000	58,990	17,000	158,990
1947	100,000	62,785	14,500	162,785
1948	100,000	79,220	17,000	179,220

It is found from the evidence that the total compensation plaintiff paid to Mr. Williams was not based purely upon the extent of the services he rendered but that it fluctuated depending upon plaintiff's annual profits and the amount of participating stock he owned.

96. In the classification of officers and directors, as used in stipulated exhibits 22 to 30, the following officers of plaintiff were included in addition to the chairman of the board for all years 1940 to 1948, inclusive: president, three or more vice presidents, treasurer, and secretary. For some of these years there were included in this classification the chairman of the executive committee, purchasing agent, manager sales department, counsel, assistant counsel, traffic manager, superintendent leaf processing, leaf supervisor, general leaf superintendent, associate counsel, manager advertising department, comptroller and assistant sales manager.

Of the officers stated above, the most important, other than the chairman of the board, were the president and chairman of the executive committee. The duties and responsibilities of the various vice presidents were similar and their jobs were somewhat comparable. Length of service, however, was considered important in evaluation of their services.

97. The evidence does not disclose in detail the duties of all of the various officers listed above, their exact responsi-

bilities, nor the reasonable value of their individual services. There is insufficient evidence in the record from which the value of the services of these individual officers and directors can be determined with any reasonable degree of certainty. The evidence of salaries paid officers and directors of other tobacco companies, for comparative purposes, is insufficient to determine with any degree of certainty the reasonableness of salary or compensation of the various individual officers and directors of plaintiff for any of the years 1940 to 1948, inclusive. The evidence does not show the nature, value, or extent of the services of all of the officers and directors of the other major companies; does not disclose the weight that should be given to stockholdings as distinguished from pure services; and does not sufficiently show the duties of the various officers and directors in each of the categories of plaintiff, or of other companies, or the corresponding duties and services of the particular officers and directors in other tobacco companies to the executives of plaintiff. The evidence also does not disclose whether the officers and directors in other tobacco companies, holding corresponding or similar titles to the officers and directors here involved, performed services similar or comparable to any executive officer of plaintiff. The evidence does show that the participation or bonus plans of the various tobacco companies were not comparable to the participation plan here.

98. As a further indication that the total compensation paid to the various officers and directors was not wholly commensurate with services or based purely upon services without regard to stock ownership, it is found that the total compensation for most of the years here concerned was less for the board chairman than for the president of the plaintiff. During much of the period from 1940-1948, however, Mr. Williams was in Washington, D. C., doing Government work of various kinds and his duties as chairman of the board devolved upon Mr. Gray, the president, during these absences. The fixed salary of the president was only half that of the chairman of the board, but in each year he owned

considerably more participating stock and received far greater payments under the bylaw.

Further, though the duties and responsibilities of the vice presidents were comparable, R. E. Lasater, a vice president, received a total compensation higher than that of two other vice presidents. Mr. Lasater was senior in service but, except for the year 1940, his fixed salary was less than that of either of the other two vice presidents. He owned more participating stock and, as with other officials and employees who owned stock, total compensation depended upon such ownership and plaintiff's profits.

Ultimate Findings.

99. The bylaw was set up to provide a plan for profit participation as an incentive to employees. However, the evidence establishes that the effect of the operation of this bylaw from 1940 to 1948, inclusive, was to reward employees, who held class A common stock, with payments from annual profits in large part because of their investment in such stock and not purely for services.

100. The evidence does not disclose the employees who purchased stock without company approval or received it as a gift or inheritance nor the number of shares of stock thus obtained by those employees without company approval.

101. It cannot be determined from the evidence that the bylaw payments, if considered as compensation for personal services, were, together with fixed salaries, reasonable as to each and every individual officer and employee for the years 1940 to 1948, inclusive.[4]

[4] Four of plaintiff's executives testified that previous to the trial they reviewed the records of all employees who participated in the bylaw distributions during the period in question. The result of the review was a determination of reasonable compensation, or partially reasonable and partially unreasonable compensation for each employee and a statement of the amount considered unreasonable where such was the case. These four witnesses then testified that, except for the payments they deemed

102. The evidence does not establish that the participation payments under the bylaw for the years 1940 to 1948, inclusive, to plaintiff's officers and employees, were otherwise ordinary and necessary business expenses to any extent, or includible as a part of the cost of goods sold, or that any particular amount of these payments was so includible.

103. It is found from the evidence that no part of the bylaw participation payments to employees of Glenn Tobacco Company represented costs of plaintiff's goods sold, or reasonable compensation, or ordinary and necessary business expenses.

Conclusion of Law.

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that the plaintiff is not entitled to recover, and the petition is therefore dismissed.

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unreasonable, all other payments under the bylaw, when added to the particular employee's fixed compensation, did not constitute unreasonable compensation. In making their examinations, the four executives took into consideration the usual factors that enter into an appraisal of the value of an employee's services including his salary and bylaw participation, ability, performance in the job, responsibility, and length of service.

The former president of a competitor testified that the aggregate amount of fixed compensation plus bylaw payments paid to the officer-director group of plaintiff as a whole was not unreasonable compensation. However, there was no direct comparison of plaintiff's officer-director group with the officer-director group of competitors by showing comparative duties, responsibilities, etc., of the individual officers or directors. This testimony of reasonableness was based solely on a comparison of the total wages paid to the officer-director group of the respective companies in proportion to sales and earnings of those companies.

The Government introduced no evidence to refute the testimony of the above witnesses as to reasonableness and introduced no evidence to prove unreasonable compensation.

It is felt, however, that the above testimony of plaintiff's executives is insufficient to prove reasonableness of the employees' compensation and that the testimony as to the officer-director group is insufficient to prove the reasonableness of the total compensation paid to any individual officer or director.

Statutes Involved.

INTERNAL REVENUE CODE OF 1939, AS AMENDED

"Sec. 22. Gross Income

(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly."

"Sec. 23. Deductions from Gross Income

(a) Expenses.—

(1)(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

"Sec. 115. Distributions by Corporations

(a) Definition of Dividend.—The term 'dividend' when used in this chapter (except in section 203 (a) (3) and section 207 (e) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made." [Amended in respects not here material by § 166 Rev. Act of 1942 and § 512(a) Rev. Act of 1943.]

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In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 535

R. J. REYNOLDS TOBACCO COMPANY, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion, findings of fact, and conclusion of law of the Court of Claims (R. 1–71) [1] are reported at 149 F. Supp. 889.

JURISDICTION

The decision of the Court of Claims was entered on April 3, 1957. (R. 1.) Taxpayer's motion for rehearing was denied July 12, 1957. The petition for a writ of certiorari was filed on October 8, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1255 (1).

[1] Record references herein are to the appendix to taxpayer's petition for certiorari.

QUESTION PRESENTED

Whether the Court of Claims was warranted in concluding that payments from earnings and profits made by taxpayer to employee-shareholders proportionate to their stockholdings were not deductible under Section 23 (a) (1) (A), Internal Revenue Code of 1939, as amended, as reasonable compensation for services actually rendered.

STATUTE AND REGULATIONS INVOLVED

Sections 22 (a), 23 (a) (1) (A), and 115 (a) of the Internal Revenue Code of 1939, and Section 29.23 (a)–6 of Treasury Regulations 111, are set forth in the Appendix, *infra*, pp. 12–14.

STATEMENT

Taxpayer, a New Jersey corporation, is engaged in the manufacture and sale of tobacco products. (R. 16–17.) In each of the years 1940 to 1948, inclusive, pursuant to a company by-law enacted in 1912, it made certain payments from earnings and profits to its employee-shareholders in proportion to the employees' stockholdings in the company. (R. 30.) It is the deductibility of those payments that is in issue. (R. 54.)

The by-law provided for an annual payment in the discretion of the board of directors, up to 10 percent of profits in excess of those earned in 1910, to employees who both owned stock and had been employed for a full year, the payments to be made in proportion to the stock owned by each such employee. (R. 26.) The amounts so paid were in addition to the em-

ployees' regular salary. Also, taxpayer paid a regular dividend on its stock to all holders, regardless of employment. (R. 32.) The by-law was amended in 1915 to allow stock acquired during the year from another officer or employee or representative of a deceased employee to qualify for participation. Thereafter the by-law remained substantially unchanged until 1949 when participating Class A stock was frozen to those shares then in the hands of employees and a plan adopted to phase out the payments. (R. 26–27, 55.) By-law payments will cease in 1958. (R. 55.)

At the time the by-law was adopted only one class of stock, numbering 75,250 shares, was outstanding. As a result of various changes in capital structure, there was outstanding during the years 1940–1948, inclusive, 1,000,000 shares of Class A common stock and 9,000,000 shares of Class B common. At all times pertinent in this case, Class B common stock had the same rights as Class A common except that Class B stockholders were not eligible for participation under the by-laws and had no voting rights. (R. 22.)

The court below found (R. 8–9) that "The purpose of the plan was obviously to encourage employees to become owners of a share of the business" so that they, "by reason of such ownership, would have a greater interest in its profitable operations and would give their best efforts to that end." Thus, the by-law was designed to provide a plan for profit participation as an incentive to employees. (R. 70.). However, in operation the plan rewarded employees who held Class A common stock with payments from annual profits

in large part because of their investments in such stock and not purely for services. (R. 70.) "As originally planned, [taxpayer] wanted only those employees 'who had the interest of the company at heart' to participate" and the plan was supervised by a company committee with this in mind. (R. 4.) While it was taxpayer's desire that participating stock should not be acquired without company approval, there was no corporate resolution concerning the manner or method under which acquisition could be made or the amount one employee could acquire. No employee was ever discharged for acquiring too much stock. In the early days of the plan, taxpayer's founder financed purchases; until 1933 taxpayer extended credit. Because of Securities and Exchange Commission rules, taxpayer has not bought its own stock for resale to employees since 1935. Employees could acquire the eligible stock by gift, exchange, purchase from other employees and holders of the stock, or purchase on the Stock Exchange, sometimes without notice to the company. (R. 4–5.) Some employees bought all of the stock they could and others, who had an opportunity to buy, did not do so for personal reasons. (R. 33–36.) In management's view, these imperfections did not affect the overall success of the plan. (R. 5.)

Payments were determined under the by-law solely on the basis of stockholding without regard to position or actual service rendered. (R. 9.) Fixed salaries of some classes of employees were found to be at the going rate in the community; others were low in comparison to competitors. (R. 5.) While four of

taxpayer's officers testified that they had reviewed the records of participating employees and all were reasonable with certain conceded exceptions, no comparative evidence was given. As to the officer-director group, comparative testimony was given, but it related only to the aggregate compensation of the group and did not directly compare the rates of compensation with those of competitors with reference to the duties and responsibilities of individual officers or directors. (R. 5–6, 13–14.)

Historically, through the years at issue and until 1949, taxpayer treated the by-law payments as dividends. (R. 10.)

ARGUMENT

1. It is submitted that the decision below that the payments to employee-shareholders were dividends rather than compensation is correct, presents essentially a factual question, and is not in conflict with any decision of this Court or with any other appellate decision.

While the motive in adopting the by-law which gave rise to the payments in issue may have stemmed from management's desire to develop in the employees a greater interest in the corporation, the effect of the operation of this by-law from 1940 to 1948, inclusive, was to reward employees, who held Class A common stock, with payments from annual profits in large part because of their capital investment in such stock, and not purely for services.

The payments were made pro rata to employee stock holdings, irrespective of the employee's fixed salary, the salary of others similarly situated, or the con-

tinued worth of the employee's services. The corporation sold no stock from 1935 and the employees could acquire stock without corporate approval from third parties or through the Stock Exchange and qualify for profit participation. Some employees acquired all the stock they could. Others, for personal reasons, bought none.

Section 23 (a) (1) (A) (Appendix, *infra*, p. 12) allows deduction of all ordinary and necessary expenses paid or incurred "including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *." Section 29.23-(a)-6, Treasury Regulations 111 (Appendix, *infra*, pp. 13–14) governing the years 1942 to 1948, inclusive, provides that in order to be deductible as compensation the payments must be based purely on services rendered. Treasury Regulations 103, Section 19.23 (a)-6, governing the years 1940 and 1941, is similar.[2]

[2] The applicable provisions of Section 29.23(a)-6 of Regulations 111 above cited have appeared in all Treasury Regulations since 1921 construing sections of the Revenue Acts containing similar provisions. See Article 105, Regulations 45 (1920 ed.); Art. 105, Regulations 62, promulgated under the Revenue Act of 1921; Article 106, Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926, respectively; Article 126, Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932, respectively; Article 23(a)-6, Regulations 86, 94 and 101, promulgated under the Revenue Acts of 1934, 1936, and 1938, respectively. It is well settled that Regulations which have continued in force substantially unchanged through successive reenactments of the statutory provisions to which they pertain must be regarded as having received Congressional approval. *Lykes* v. *United States*, 343 U. S. 118, rehearing denied, 343 U. S. 937; *Commissioner* v. *Wheeler*, 324 U. S. 542; *Morrissey* v. *Commissioner*, 296 U. S. 344.

The court below noted by numerous illustrations (R. 10–11) that taxpayer historically and through the years at issue treated the by-law payments as dividends. While not binding, these illustrations are certainly indicative of taxpayer's intent and their consideration by the Court of Claims as a pertinent factor is certainly permissible. Indeed, in answer to a stockholder's derivative suit charging that the participation payments when combined with fixed salaries resulted in excessive compensation, taxpayer alleged the payments were dividends, and the court so held. *Bookman* v. *R. J. Reynolds Tobacco Co.*, 138 N. J. Eq. 312.[1]

The question whether payments made to one enjoying the dual capacity of employee and stockholder are dividends or compensation must turn on the facts of the case and the holding that payments proportioned to stockholdings are dividends and are not compensation is not new. See *Twin City Tile & Marble Co.* v. *Commissioner*, 6 B. T. A. 1238, dismissed, 32 F. 2d 229 (C. A. 8th); *Marble & Shattuck Chair Co.* v. *Commissioner*, 13 B. T. A. 657, affirmed, 39 F. 2d 393 (C. A. 6th); *Doernbecher Mfg. Co.* v. *Commissioner*, 95 F. 2d 296 (C. A. 9th); and *Bridges-Smith Co.* v. *Glenn* (W. D. Ky.), decided March 18, 1939 (24 A. F. T. R. 1212), affirmed *per curiam*, 116 F. 2d 934 (C. A. 6th).

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[1] As recited by the court, taxpayer contended as follows: "They assert that the amounts payable under the by-law had three characteristics: (1) they were payable only out of profits; (2) they were payable only as an extra dividend on stock owned by an employee; and (3) in proportion to the stock owned." 138 N. J. Eq. at 384.

Despite taxpayer's assertion to the contrary, it is submitted that the holding below is not in conflict with this Court's decision in *Commissioner* v. *LoBue*, 351 U. S. 243, rehearing denied, 352 U. S. 859. The question in that case was whether income was to be recognized upon the transfer of property (stock) to an employee at less than fair market value. The lower courts had held, that as the stock options were primarily intended to provide the employee with a proprietary interest in the corporation, their exercise did not result in present gain. This Court held that this interpretation of Section 22 (a) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 12) was too narrow. Thus, the issue in *LoBue* was whether the exercise of the option resulted in a gift or compensation, whereas the issue here is whether the payments are compensation or dividends.

The issue in *Commissioner* v. *LoBue* arose upon the acquisition of stock, whereas here the question involves the nature of subsequent payments to the stockholder. The receipt of income here requires a dual status (that the recipient be both a stockholder and employee) whereas prior to receipt of income it was necessary only that Mr. LoBue be an employee. Therefore, no dividend question could have been involved under the facts in that case.

Further, there was no suggestion in *Commissioner* v. *LoBue* that, because the stock was acquired as compensation, subsequent payments thereon would be compensation rather than dividends even though the benefit to the corporation from establishment of a proprietary interest in the employee continues as

long as his dual status as stockholder and employee lasts.

The Tax Court in a case involving this taxpayer for later years (1949–1950) held some part of the by-law payments there involved deductible as reasonable compensation. *R. J. Reynolds Tobacco Co.* v. *Commissioner,* decided July 6, 1956 (1956 P-H T. C. Memorandum Decisions, par. 56, 161). Final decision was entered by the Tax Court on October 15, 1957. While we believe that decision to be wrong, as noted by the court here below (R. 15):

> * * * the [Tax] court in that case was deciding the nature of the payments made pursuant to a different bylaw, on a different record, and for different years than the ones in question here.

2. As a second and independent ground for denying taxpayer's refund claim, the Court of Claims held that assuming, *arguendo,* that the payments were compensation, the taxpayer has failed to establish the reasonableness thereof.* Taxpayer's complaint seems to be, in short, that the decision is contrary to the evidence.

Section 23 (a) (1) (A) includes among deductible business expenses a "reasonable allowance" for compensation for personal services. Deductions are a matter of legislative grace and the burden of establishing one's right thereto is on the taxpayer. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590; *Deputy* v. *duPont,* 308 U. S. 488, 493; *New Colonial*

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* Two judges concurred on the first issue but refrained from passing on the issue of reasonableness. (R. 16.)

Co. v. *Helvering*, 292 U. S. 435, 440. A salary deduction will be disallowed unless its reasonableness is clearly proved. *L. E. Pinkham Med. Co.* v. *Commissioner*, 128 F. 2d 986 (C. A. 1st), certiorari denied, 317 U. S. 675. While the Commissioner believed the payments to be dividends rather than compensation, this did not relieve taxpayer of the normal burden of establishing his right to the claimed deduction; *i. e.*, not only that the payments were compensation but also that they were reasonable. Significantly, the objections which the Court of Claims found with the probative value of the testimony of taxpayer's officers and the comparative data produced likewise led the Tax Court, in its consideration of later years, to consider this evidence inadequate to establish reasonableness. *R. J. Reynolds Tobacco Co.* v. *Commissioner, supra.* While the Tax Court, on the record before it, came up with a formula of its own by applying the principles of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. A. 2d),[5] the Court of Claims found it was unable to de-

[5] In that case taxpayer, a well-known entertainer, had been denied any allowance for entertainment and travel expense because he had failed to itemize or detail his expenses. Holding that it was clear that some amounts were spent and that absolute certainty in such matters was usually impossible, the Court of Appeals ordered the trial court to make an approximation, bearing heavily if it chose on the taxpayer whose inexactitude was of his own making. But this does not compel the trier of the fact to make an uninformed, wholly insupportable guess. As stated in *Williams* v. *United States*, 245 F. 2d 559, 560 (C. A. 5th):

> For the basic requirement is that there be sufficient evidence to satisfy the trier that *at least* the amount allowed in the estimate was in fact spent or incurred for the stated purposes. Until the trier has that assurance from the record, relief to the taxpayer would be unguided largesse.

vise any such formula. Cf. *L. Schepp Co.* v. *Commissioner*, 25 B. T. A. 419, 429–430.

Of course, the fact that the amount of payments to some employees was small, does not of itself prove reasonableness, for the measure of reward under the plan was stockholding rather than actual service rendered. Further, as some stock was acquired without the company's approval through purchase, gift, or inheritance, no intent to compensate could be inferred from payment.

The various appellate cases cited (Pet. 17) with which conflict is alleged are simply a group of cases, predicated on a variety of factual settings where appellate courts have reversed a trial court's holding as being clearly erroneous, where the lower court had disregarded uncontroverted opinion testimony. None poses a conflict in principle with the instant case and none involved a situation of employee-stockholders receiving payments exactly in proportion to their stockholdings without reference to the extent or value of their services.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 23 [As amended by Section 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

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(26 U. S. C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23 (a)–6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings

of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services but in part constitute payment for the transfer of their business.

* * * * *

Section 19.23 (a)–6, Treasury Regulations 103, promulgated under the Internal Revenue Code of 1939, applicable for the years 1940–1941, contains like provisions.